

# UBS House View

Monthly Base **July 2016**

**Chief Investment Office WM**

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# Summary

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"Despite political uncertainties we think the global economic backdrop is supportive of a moderate risk-on positioning of our diversified portfolios"

- **Asset allocation**

Political uncertainty in Europe and a soft patch in US employment data led to elevated market volatility over the past month. Global government bond yields dropped sharply, with the 10-year US Treasury yield falling to the lowest level since 2012. While the outcome of political events is notoriously difficult to predict, the global economic backdrop remains on balance positive. US employment is at a record high, while the unemployment rate has fallen to 4.7% – the lowest level since 2007 – and private consumption is solid, as highlighted by record-strong car sales. Eurozone growth indicators are pointing towards a further acceleration. Meanwhile, global central banks continuously support economies and financial markets with loose monetary policy. Our portfolios, including moderate tactical overweight positions in US equities and euro high yield bonds, are well positioned to perform over the next six months.

- **Equities**

European equities suffered a setback over the past month, while US stocks held onto their year-to-date gains. We keep our only overweight position in the equity space in US equities over high grade bonds, as we expect US corporate earnings to recover in the second half of the year. The domestic growth backdrop, including the labor market and despite the drop in non-farm payroll growth last month, is supportive. Additionally, the US dollar has retreated from previously elevated levels, the oil price has bounced off its multi-year low in recent months and corporate funding costs are still very cheap, supporting a recovery in earnings. The destruction in oil-related investments has proceeded further and will thus pose less of a drag on overall investments and GDP growth.

- **Bonds**

The recent sharp fall in government bond yields provided a tailwind to fixed income asset classes. Concerns around the US growth outlook and a re-pricing of Fed rate hike expectations have been the driving factors. We think the market reaction has been overdone, as we believe the US economy remains on a solid growth path. We therefore expect yields to grind higher again over the next six months, weighing on high grade bond returns. We are holding an overweight position in euro high yield bonds, which offer attractive yield pick-up and persistently low default risks. The start of the ECB's corporate bond purchases in June provides an additional tailwind. Also, US investment grade corporate bonds are more attractive than high grade bonds.

- **Foreign exchange**

We are maintaining tactical positions in the Norwegian krone over the euro and in the US dollar over the Australian dollar. Positive economic momentum in Norway and an inflation gap of 3.5 percentage points towards the Eurozone should support further appreciation of the NOK. The Norwegian central bank is constructive on the domestic economic outlook, while the ECB is keeping a very easy stance. The US economy is in a fundamentally better position than Australia, which still suffers from its dependence on commodity exports and emerging market demand. Meanwhile, we still expect the Fed to proceed with hiking policy rates in the next six months, supporting the USD against the AUD.

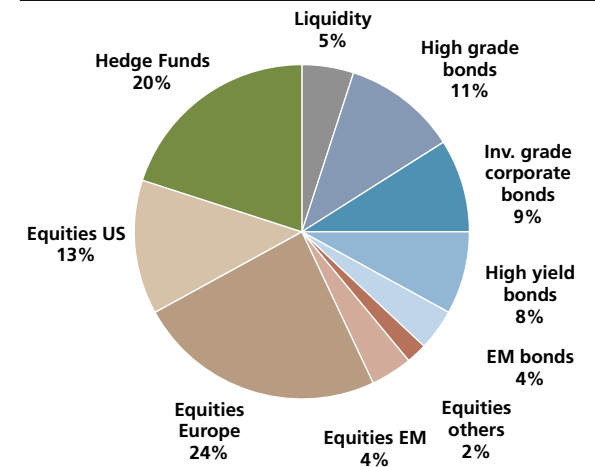
- **Alternative investments and precious metals & commodities**

Despite their weak start to the year, hedge funds remain an important part of our well-diversified portfolios, providing access to alternative return drivers. Over the next 12 months we expect hedge funds to generate average returns in line with the experience of 2012-2015, rather than repeating the disappointing returns of early 2016. We particularly prefer equity event-driven hedge funds, which are best positioned to benefit from elevated corporate deal activity. Our expected return profile for broadly diversified commodity indices over the next three to six months is negative. We are currently not recommending any direct commodity exposure.

# Cross-asset preferences

	Most preferred	Least preferred
<b>Equities</b>	<ul style="list-style-type: none"> <li>● US equities</li> <li>● US share buybacks and dividends</li> <li>● US technology</li> <li>● Water-linked investments</li> </ul>	
<b>Bonds</b>	<ul style="list-style-type: none"> <li>● US investment grade</li> <li>● Euro high yield</li> <li>● Corporate hybrids</li> <li>● Rising stars</li> <li>● US leveraged loans</li> </ul>	<ul style="list-style-type: none"> <li>● Developed market high grade bonds</li> </ul>
<b>Foreign exchange</b>	<ul style="list-style-type: none"> <li>● NOK</li> <li>● USD</li> </ul>	<ul style="list-style-type: none"> <li>● EUR</li> <li>● AUD</li> </ul>
<b>Hedge Funds &amp; Private Markets</b>	<ul style="list-style-type: none"> <li>● Hedge funds: Event-driven strategies</li> </ul>	
<b>Precious Metals &amp; Commodities</b>		

## Global model portfolio (EUR)



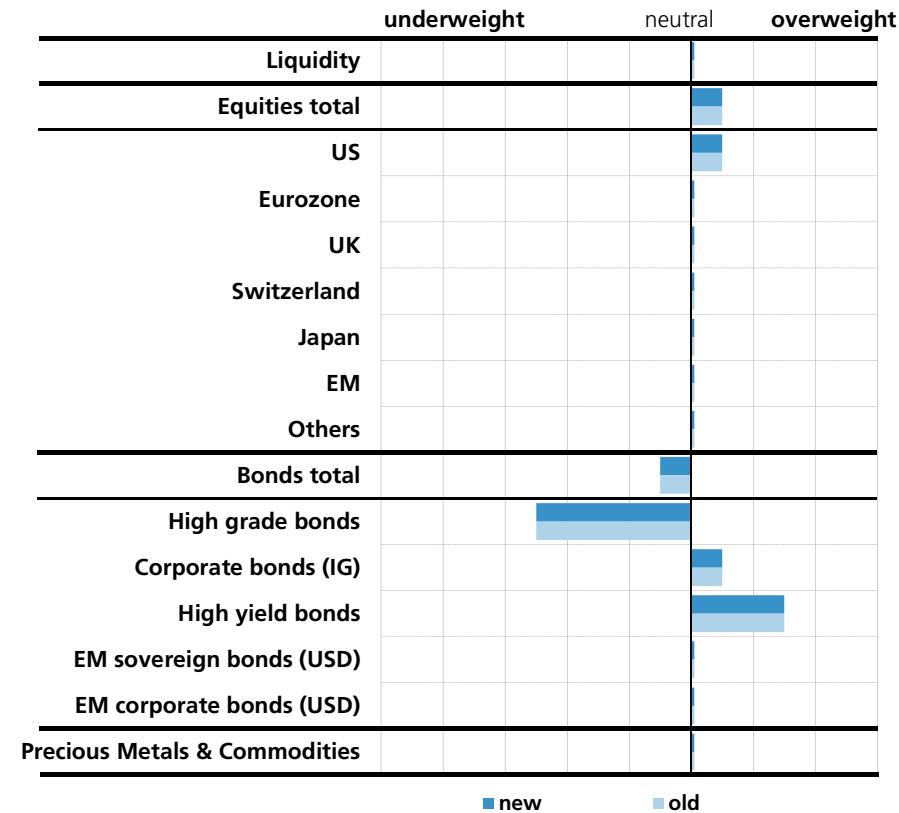
As of 22 June 2016

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 4.2% p.a. and volatility of 8.2% p.a. over the next five years.

↗ Recent Upgrade   ↘ Recent Downgrade

# Global tactical asset allocation

## Tactical asset allocation deviations from benchmark\*

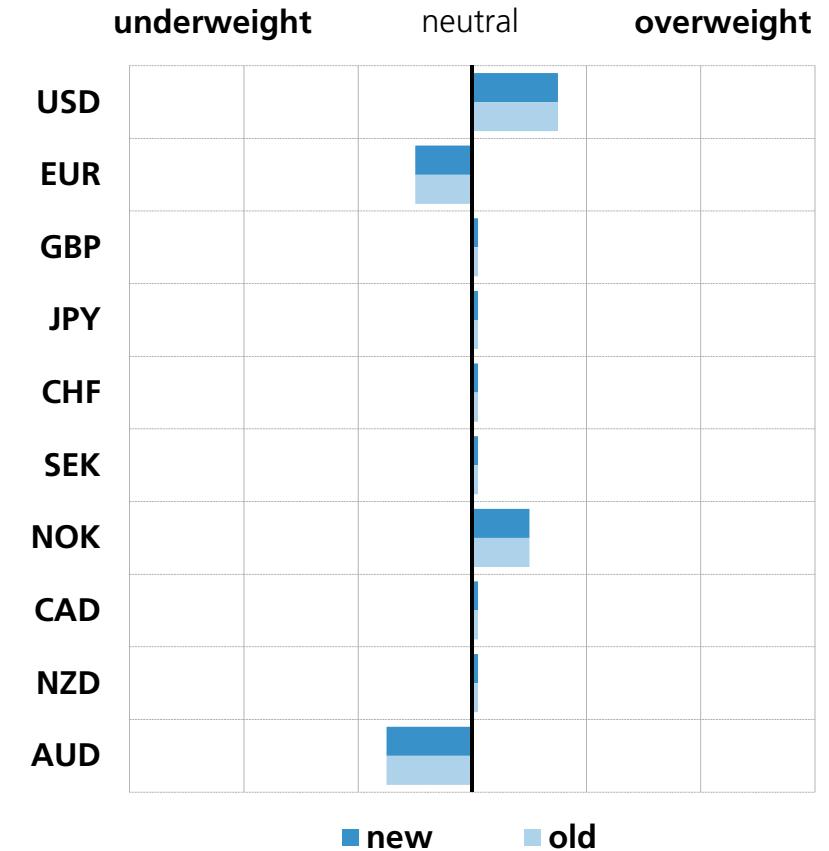


Source: UBS, as of 22 June 2016

\*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 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

- **US technology: Secular growth, on sale**

Secular growth drivers (online advertising, cyber security, cloud investments) are likely to propel US technology sector earnings over the coming years. More tactically, we expect the sector to continue to benefit from resilient business spending and ongoing labor market gains. Relative valuations are near 20-year lows and companies are returning large sums of cash to shareholders without increasing leverage.

- **Profit from US share buybacks and dividends**

US companies generally have healthy balance sheets, with many 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 the demand for clean water. However, climate change and urbanization pressure supply, which in emerging markets is constrained by insufficient water infrastructure and a greater focus by governments on the industrial sector. We have identified two short-term trends that should add to the earnings power of water-exposed companies: ship ballast water treatment and desalination.

## 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 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 the BBB rating categories. Even without an upgrade, we expect them to outperform investment grade corporates due to higher carry and potential further spread compression.

- **US loans – Attractive floating yield**

We believe US senior loans are an attractive alternative to more traditional fixed income segments. Loans provide exposure to the most senior part of a company's capital structure and are often secured by the company's assets, leading to higher recovery rates than for bonds. Also, loans offer a floating coupon rate, which would benefit from a rise in short-term US interest rates. The yield (to 3-year takeout) at roughly 6.3% is attractive. Our default rate forecast of 3% in 12 months suggests a tightening of loan credit spreads. With an index weight of 4.4%, exposure to the oil and gas sector is much more limited than in US high yield bonds. We think US loans present an attractive investment opportunity for qualified investors who are comfortable holding less liquid asset classes.

- **Euro high yield - Diversify your credit exposure**

Euro high yield offers an attractive yield pick-up relative to higher-rated bonds, especially as we expect defaults to rise only moderately toward 2% in the next 12 months. Corporate fundamentals are solid and the ongoing Eurozone economic recovery supports earnings. The ECB's support measures, in particular the corporate bond purchases that started in June, are a continued tailwind. They target credit markets and the important bank sector directly and encourage investors to reach for yield. Our six-month total return expectations are 2–3%. Given euro high yield's attractive risk-return profile, we recommend investors who do not yet have exposure to add an allocation to euro high yield as it enhances portfolio diversification.

- **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

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## *Alternative investments*

- **Exploring the benefits of equity event-driven strategies**

The environment for mergers and acquisitions continues to look compelling amid high corporate cash levels, elevated executive confidence and companies' willingness to buy targets that meet their strategic/growth objectives. Annualized deal spreads offer attractive opportunities and hint at high rates of return for merger arbitrage strategies and to a certain extent for special situations funds. For the latter, we acknowledge that renewed equity market turbulences could affect performance in the short term.

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 vary. Emerging markets should stabilize at lackluster levels.
- We believe inflation will remain subdued globally, even if divergences among countries increase.
- The policies of major central banks are expected to diverge. The US Federal Reserve hiked rates in December and is likely to raise them again this year, while the ECB is set to remain on hold for the time being.

## CIO view (Probability: 60%\*)

### Stable world growth this year

- We expect global economic growth to hold up this year, with most developed nations faring well and emerging markets (EM) stabilizing at lackluster levels relative to their historical growth rates.
- We expect moderate US economic growth. In Europe, sound domestic fundamentals should limit negative spillovers from external shocks. Within EM, Asia is still the strongest region despite slowing growth in China. EMEA and Latin America are lagging due to weakness in Russia and Brazil, but both should recover next year.
- Inflation in the developed world should reaccelerate in the second half of the year due to stabilizing oil prices, while subdued growth is expected to restrain inflation in emerging markets.
- The Fed hiked rates in December and is expected to raise them again this year, but policy should remain accommodative. The Bank of Japan should continue with its expansive monetary policy. The ECB is in wait-and-see mode after announcing a major easing package in March.

## Positive scenario (Probability: 20%\*)

### Return to above-trend growth

- The US economy grows above 2.5%, spurred by consumer spending. Risks in the Eurozone fade, especially political ones. Growth and inflation beat forecasts, especially on 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: 20%\*)

### Global growth disappointments

- The Eurozone crisis deepens again. Worsening deflationary pressure and economic disappointments push the ECB to ease monetary policy further.
- The Chinese economy weakens abruptly due to a sharper downturn in investment and manufacturing, 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 and the Middle East) deepen, affecting global risk sentiment, and potentially push oil prices higher again.

\*Scenario probabilities are based on qualitative assessment.

## Key dates

<b>Jun 30</b>	Eurozone: HICP inflation (June Estimate)
<b>Jun 30</b>	Japan: Industrial production (May)
<b>Jul 8</b>	US: Nonfarm payrolls (June)
<b>Jul 15</b>	China: GDP (2Q)

## Global growth broadly stable this year

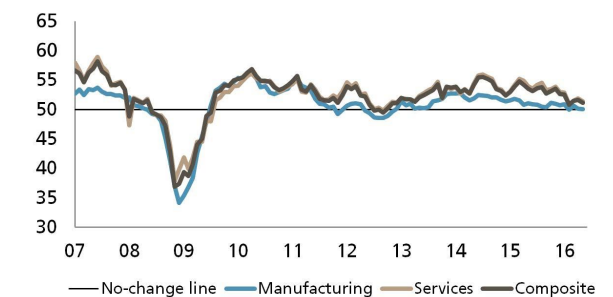
		Real GDP growth in %			Inflation in %		
		2015	2016F	2017F	2015	2016F	2017F
<b>Americas</b>	US	2.4	1.7	2.5	0.1	1.3	2.2
	Canada	1.2	1.9	2.5	1.1	1.7	1.9
	Brazil	-3.8	-3.5	0.8	10.7	6.4	4.7
<b>Asia/Pacific</b>	Japan	0.6	0.5	1.1	0.8	0.0	0.5
	Australia	2.5	2.5	2.7	1.5	1.3	2.0
	China	6.9	6.6	6.3	1.4	1.9	2.0
	India	7.6	7.4	7.6	4.9	4.6	4.2
<b>Europe</b>	Eurozone	1.6	1.6	1.7	0.0	0.2	1.5
	Germany	1.5	1.6	1.5	0.1	0.3	1.6
	France	1.2	1.5	1.7	0.4	0.1	1.5
	Italy	0.6	1.1	1.2	0.1	0.0	1.6
	Spain	3.2	2.9	2.2	-0.6	-0.5	1.7
	UK	2.3	2.0	2.3	0.0	0.6	1.5
	Switzerland	0.8	1.0	1.5	-1.1	-0.3	0.4
	Russia	-3.7	-0.6	1.5	15.5	7.1	5.4
<b>World</b>		3.2	3.0	3.4	3.5	3.6	3.4

Source: UBS, as of 21 June 2016

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 in expansionary territory

Global purchasing managers' indices (PMIs)



Source: Haver Analytics, UBS, as of May 2016

# Key financial market driver 1 - *Moderate growth in the US*

## Key points

- We expect the US to grow at a moderate pace over the next 12 months.
- Inflation should gradually trend higher as the recovery continues.
- The Fed hiked rates in December and should raise them more this year.

## CIO view (Probability: 60%\*)

### Moderate expansion

- We expect the US to grow at a moderate pace over the next 12 months. The labor market is still improving, with the unemployment rate below 5% and signs that labor shortages are promoting faster wage growth. Rising household income and low energy prices should enable robust consumer spending.
- Housing starts and home prices should remain on an upward trend, contributing modestly to overall economic growth.
- Energy sector fixed investment appears to be bottoming out following the rebound of oil prices. The manufacturing sector has been restrained by weak global demand and the strong dollar but is now stabilizing, with the PMI remaining above 50 since March.
- An inventory correction cycle has been a drag on growth since the second half of last year, but appears to be nearing its end.
- Personal consumption expenditure (PCE) price inflation has been held in check by the strong US dollar, low energy prices and smaller-than-usual increases in healthcare costs. These factors are fading, and with the labor market getting tighter inflation is firming.
- Fiscal policy will be slightly positive for growth this year, as politicians agreed to spending increases and tax cuts ahead of the presidential election. Major policy reforms are unlikely until after the new president takes office in January 2017. Political uncertainty is a potential downside risk for growth.
- The Fed hiked rates by 25 basis points in December and is likely to raise rates more before the end of the year.

## ↗ Positive scenario (Probability: 15%\*)

### Strong expansion

- US real GDP growth rises above 2.5%, propelled by expansive monetary policy, strong household spending and subsiding risks overseas. The Fed raises policy rates significantly more than markets anticipate.

## ↘ Negative scenario (Probability: 25%\*)

### 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 stays on hold this year.

\*Scenario probabilities are based on qualitative assessment.

## Key dates

<b>Jun 29</b>	Personal income and spending for May
<b>Jul 1</b>	ISM manufacturing for June
<b>Jul 6</b>	ISM non-manufacturing for June
<b>Jul 6</b>	Minutes of June 14-15 FOMC meeting

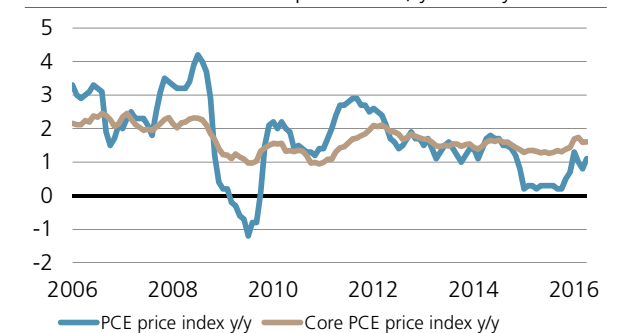
## PMIs consistent with moderate growth

### Purchasing managers' indices



## Inflation should gradually move toward the Fed's 2% target

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





# Key financial market driver 2 - *Solid Eurozone growth*

## Key points

- We expect economic growth to remain solid despite global hindrances.
- Inflation should start to rebound in the summer for several quarters.
- The ECB would need more pressure for it to ease monetary policy.

## CIO view (Probability: 50%\*)

### Steady growth

- We expect the Eurozone economy to weather global growth concerns thanks to a positive fiscal stance and a strong monetary impulse. Inflation is set to start rising in the summer through early next year. The ECB is in wait-and-see mode, requiring more pressure for it to ease monetary policy.
- In Germany, fundamentals such as consumer confidence and capital-expenditure planning remain robust. The immigration situation is helping the economy grow through greater-than-expected government spending. In France, better dynamics in construction and investments are helping solidify growth.
- In the periphery, Italian growth should consolidate, supported by its construction sector and greater regulatory visibility in its banking sector. Spain, in turn, is still posting strong growth. But this should moderate given the uncertain political situation and forthcoming fiscal adjustments.

## ↗ Positive scenario (Probability: 20%\*)

### Better-than-expected growth

- The global economy reaccelerates and the euro declines more than expected. Eurozone loan demand and the economy recover faster than envisaged. Political risks fade further.

## ↘ Negative scenario (Probability: 30%\*)

### Deflation spiral

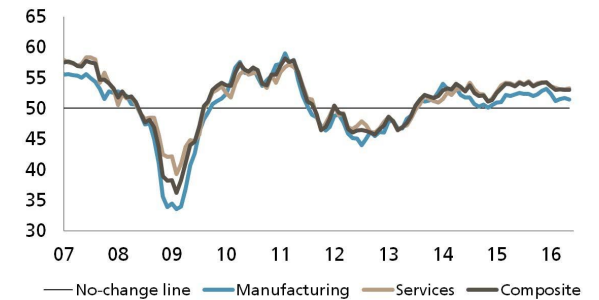
- The Eurozone slips into a deflationary spiral due to a shock, such as Greece leaving the Eurozone, a sharp escalation in the Ukraine conflict or China suffering a severe economic downturn.

\*Scenario probabilities are based on qualitative assessment.

## Key dates

<b>Jun 23</b>	Markit PMIs (June preliminary)
<b>Jun 30</b>	HICP inflation (June estimate)
<b>Jul 5</b>	Retail sales (May)
<b>Jul 13</b>	Industrial production (May)
<b>Jul 21</b>	ECB press conference

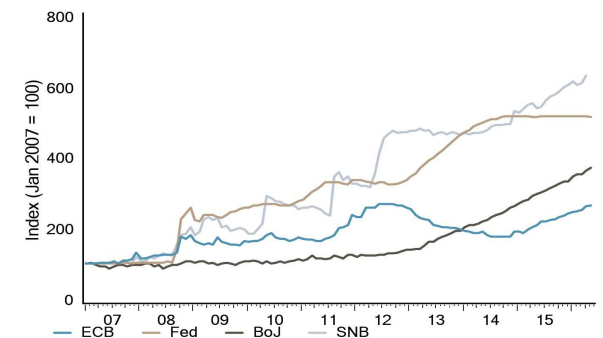
## Eurozone composite PMI expected to remain solid



Source: Haver Analytics, UBS, as of May 2016. Note: PMI = purchasing manager's index

## ECB balance sheet boosted by QE and TLTROs

Total assets in national currency (Index: 2007=100)



Source: Haver Analytics, UBS. Data as of May 2016 (SNB, as of April 2016)

# Key financial market driver 3 - *China's orderly deceleration*

## Key points

- China's economic policy tone appears to have shifted, with supply-side reforms now the current focus.
- Fiscal policy this year will be critical in supporting small and medium-sized enterprises and new manufacturing sectors.
- We expect accommodative policy to guide and facilitate China's economic transformation, thereby averting a hard landing.

## CIO view (Probability: 80%\*)

- China's economic growth has decelerated again after the one-off surge in March. Jan-May fixed asset investment (FAI) growth slowed significantly to 9.6% y/y, dragged down by FAI manufacturing and real estate. Notably, private investment fell sharply to 3.9%, which was highlighted as the No. 1 risk in the interview with "a person with authority." May exports contracted 4.1% y/y after a 1.8% decline in April on weaker external demand; this is consistent with weaker PMIs readings among China's major trading partners. May retail sales growth edged down to 10.0% y/y from 10.1% in April. As a whole, we expect an orderly deceleration with a prolonged "L-shaped" economy amid a balance between mild reforms and economic stability.
- Fiscal policy this year is expected to play a more critical role in supporting small and medium-sized firms via cost-saving measures and tax reforms, and in promoting new manufacturing sectors through government-involved private equity funds and fiscal credits. The 2016 fiscal deficit is expected to reach 4% of GDP, which is about CNY 20trn in fiscal spending.
- Monetary policy will remain accommodative. The PBoC prefers liquidity injection via open market operation and short and long-term lending facilities. A priority for monetary policy will be avoiding systematic or regional financial risks, given the worsening credit environment amid the economic slowdown. Measures such as debt-to-equity swaps and asset-backed securities are expected to be adopted to resolve the banking bad loans over the three coming years.
- CPI inflation is expected to rise mildly this year, mainly due to higher pork prices and a low base. May and 1Q CPI inflation were 2.0% and 2.1% respectively. The May PPI fell 2.8%, rebounding but remaining negative.
- The housing market continues to face downward pressure given the inventory overhang in tier-3 and tier-4 cities. The recent fever in tier-1 and tier-2 cities has done little to resolve serious inventory issues as a whole. We expect constraint policies for housing in tier-1 and tier-2 cities and supportive measures in tier-3 and tier-4 cities.

## ➤ Positive scenario (Probability: 10%\*)

- Annual growth reaches 6.8% year on year as a result of more substantial policy stimulus measures from the government or a strong pickup in external demand.

## ➤ Negative scenario (Probability: 10%\*)

- A hard landing materializes, 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 widespread credit events.

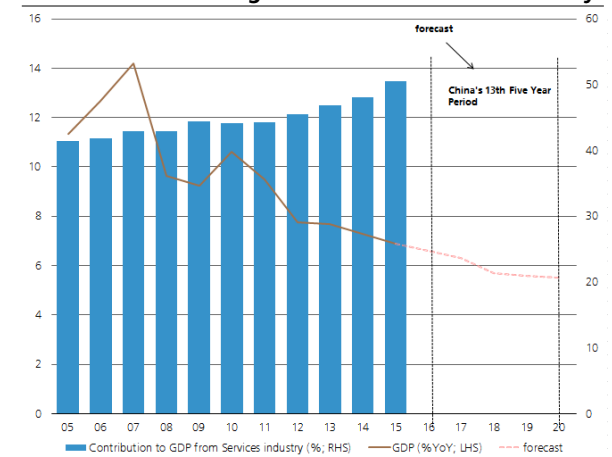
\* Scenario probabilities are based on qualitative assessment.

## Key dates

<b>Jul 10</b>	CPI, PPI for June
<b>Jul 13</b>	Trade data for June
<b>Jul 10-15</b>	Monetary and credit data for June
<b>Jul 15</b>	Industrial production, fixed asset investment, retail sales for June

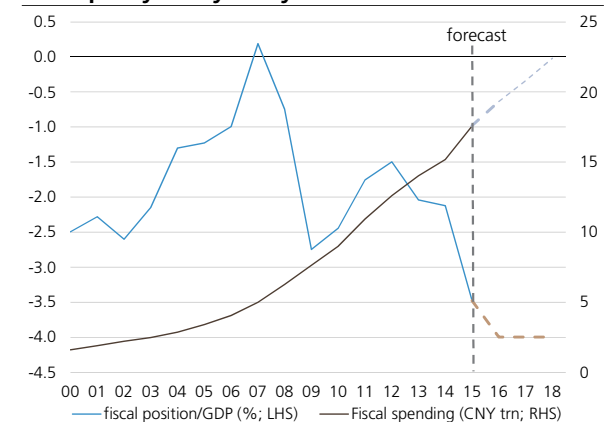
## Policy support to moderate slowdown

## China is transitioning to a services-driven economy



Source: CEIC, UBS, as of 14 June 2016

## Fiscal policy is key this year



Source: CEIC, UBS, as of 14 June 2016

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