

UBS House View

Monthly Base **May 2016**

Chief Investment Office WM

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This document is a snapshot view. We update the tactical asset allocation as changes occur and resend it to subscribers. For all other forecasts and information, we advise you to check the Investment Views section in your E-Banking or in Quotes.

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Summary

"Our moderate overweight positions in US equities and euro high yield bonds are well supported by global growth and easy monetary policy"

- **Asset allocation**

Global economic growth is holding up well as expected, driven by the ongoing economic expansion of the US and the gradual growth improvement in Europe. The weakness in the global manufacturing sector seems to have bottomed. And major headwinds to US growth in 2015 and early 2016 – specifically the strength of the US dollar, ultra-low energy prices and high corporate credit spreads – are fading. European indicators are pointing towards an ongoing mild recovery in economic growth. Emerging markets have recently shown tentative signs of stabilization in economic data. Fears about a strong devaluation of the Chinese yuan and a potential economic "hard landing" gave way to mild optimism, as capital outflows moderated markedly. Our base case remains for China's growth to gradually moderate further, but remain above 6%. Meanwhile, global central banks contributed to the improvement in investor sentiment by maintaining expansionary monetary policies.

- **Equities**

Global stock prices have recovered most of their losses from earlier in the year; US and emerging market stocks have even turned positive year-to-date. We are holding a tactical overweight in US equities versus high grade bonds. US corporate earnings are expected to return to a positive growth rate through the year. Earnings results for the first quarter, which have been released so far, are negative but have on average exceeded analysts' expectations. We are closing our overweight in Eurozone against emerging market (EM) equities given the stabilization in EM economic data and the fading headwind from falling commodity prices. While corporate earnings are still falling, investor sentiment towards EM assets has clearly turned positive in recent months.

- **Bonds**

We maintain our tactical overweight in euro high yield (HY) bonds, which currently offer a 4.8% yield. We see potential for spreads to tighten moderately and thus outperform high grade bonds due to their very limited exposure to the troubled energy sector, their better credit quality compared to the US and the ongoing monetary support – particularly through the ECB's new corporate bond purchase program. We hold an overweight in US investment grade (IG) bonds with medium maturities (1-10 years) over high grade bonds. US IG bonds currently offer a 2.6% yield. We are neutral on US HY bonds as spreads have tightened to slightly expensive levels, pricing in the expected increase in default rates to 5-6% in 12 months.

- **Foreign exchange**

We are opening an overweight position in the USD against the AUD, as we expect a market re-pricing of Fed rate hikes, while a weaker AUD is needed to support economic adjustment. We are maintaining an overweight position on the CAD against the AUD. Meanwhile, we are closing our underweight in the JPY against the USD as the risk-return outlook for the trade has weakened. The fact that the Bank of Japan has not acted despite weaker economic conditions and consumer prices dipping back into negative territory makes us less confident in the outlook for a weaker JPY. We furthermore hold an overweight position in the NOK against the EUR as the improving Norwegian economy and relatively high inflation rate speak for appreciation of the NOK against the EUR.

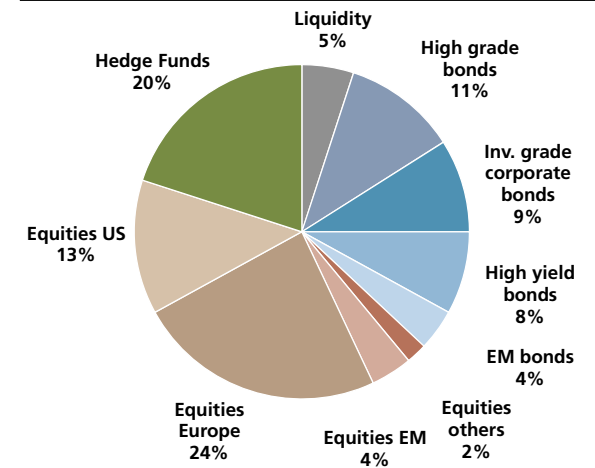
- **Alternative investments and precious metals and commodities**

Among alternative asset classes, equity event-driven hedge funds are best positioned to benefit from elevated corporate deal activity. The M&A environment continues to look compelling amid high corporate cash levels and constructive executive confidence. Within commodities, oil recently stabilized at a price above USD 40/bbl, helped by unexpected production outages in Kuwait and the ongoing reduction in drilling activity in the US. We continuously advise against direct commodity exposure within well-diversified portfolios, based on an unattractive risk-return outlook.

Cross-asset preferences

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

Global model portfolio (EUR)



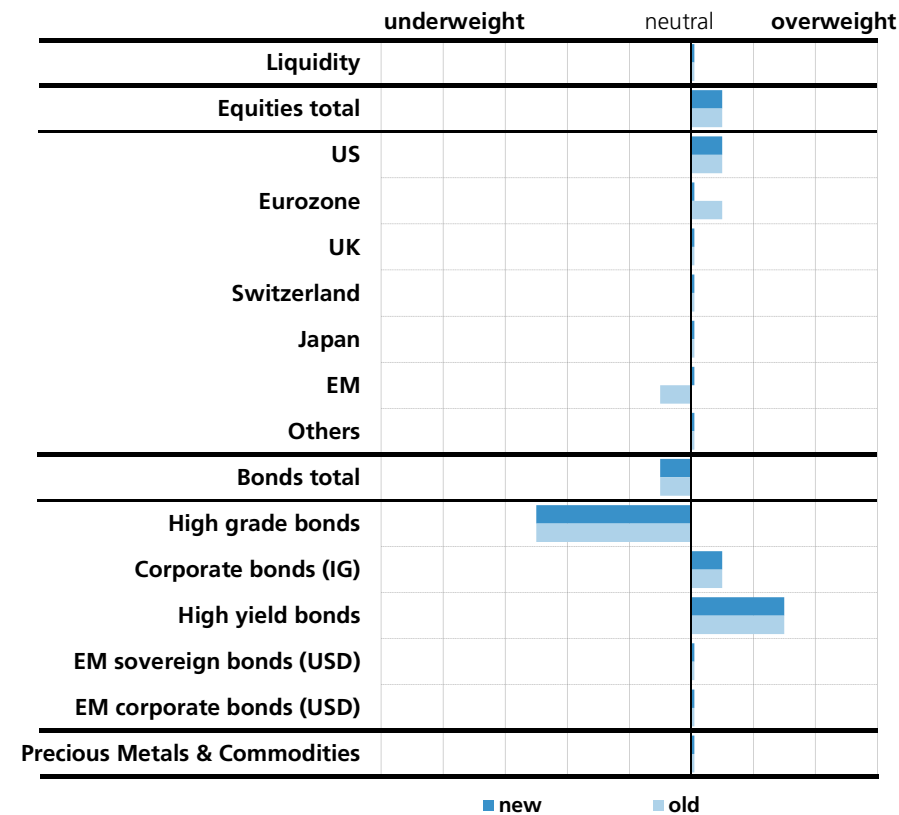
As of 28 April 2016

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*

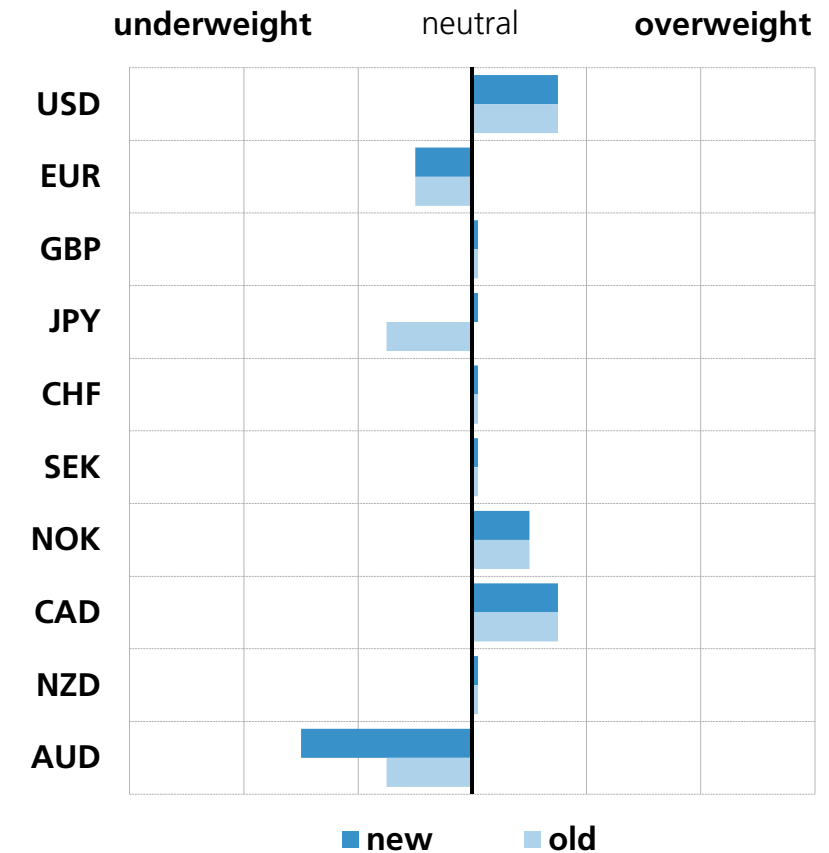


Source: UBS, as of 28 April 2016

*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 largely 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. Many are 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. The yield (to 3-year takeout) at roughly 6.7% is attractive, while we think prices should continue to recover from current levels as sentiment improves. We think these levels present an attractive entry opportunity for qualified investors, who are comfortable holding less liquid asset classes. Our default rate forecast of 3.5% 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.

- **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 towards 2% in the next 12 months. Corporate fundamentals are solid and the ongoing Eurozone economic recovery supports earnings. The ECB's support measures are a continued tailwind as they now target credit markets and the important bank sector directly and encourage investors to reach for yield. Our six-month total return expectations are 2-4%. 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

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, while emerging markets remain the weakest link.
- 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 2015 and is expected to raise them again in 2016, while the ECB is set to remain on hold for the time being.

CIO view (Probability: 60%*)

Stable world growth in 2016

- We expect global economic growth to hold up in 2016, with most developed economies faring well and emerging market (EM) economies remaining weak relative to historical levels.
- 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, while EMEA and Latin America are lagging due to weakness in the Russian and Brazilian economies.
- Inflation in the developed world should reaccelerate in the second half of 2016 due to stabilizing oil prices, while subdued growth is expected to restrain inflation in emerging markets.
- The Fed hiked rates in December 2015 and is expected to raise them again in 2016, but policy will remain accommodative. The Bank of Japan should continue with its expansive monetary policy. The ECB is in a wait and see mode after the announcement of the strong 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, coupled with economic disappointments, pushes the ECB to ease monetary policy even 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 the 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

Apr 29	Eurozone: GDP (1Q estimate)
May 2	US: ISM Manufacturing (April)
May 8	China: Trade Balance (April)
May 12	Eurozone: Industrial Production (March)

Global growth broadly stable in 2016

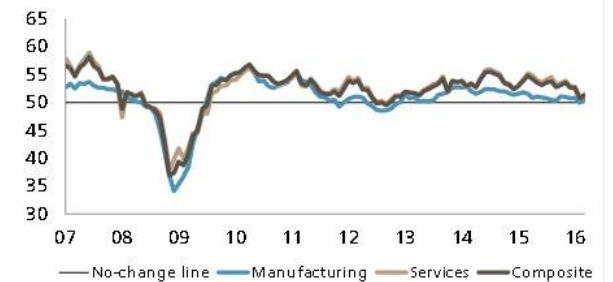
		Real GDP growth in %			Inflation in %		
		2015	2016F	2017F	2015	2016F	2017F
Americas	US	2.4	1.5	2.5	0.1	1.4	2.6
	Canada	1.3	2.0	2.5	1.5	1.7	1.9
	Brazil	-3.8	-3.8	0.6	10.7	6.8	5.2
Asia/Pacific	Japan	0.6	0.8	0.4	0.8	0.2	0.8
	Australia	2.5	2.5	2.7	1.5	1.7	2.4
	China	6.9	6.6	6.3	1.4	1.9	2.0
	India	7.6	7.4	7.6	4.9	4.6	4.2
Europe	Eurozone	1.5	1.4	1.7	0.0	0.3	1.5
	Germany	1.5	1.4	1.6	0.1	0.1	1.3
	France	1.1	1.2	1.7	0.1	1.1	1.4
	Italy	0.6	1.2	1.5	0.1	0.6	1.5
	Spain	3.2	2.6	2.2	-0.6	-0.4	1.6
	UK	2.2	2.0	2.3	0.0	0.5	1.7
	Switzerland	0.9	1.0	1.5	-1.1	-0.7	0.2
World		3.1	2.9	3.4	3.5	3.7	3.5

Source: UBS, as of 25 April 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 April 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 further in 2016.

CIO view (Probability: 70%*)

Moderate expansion

- We expect the US to grow at a moderate pace over the next 12 months. The labor market is still improving, with solid job growth and signs of faster wage growth. Rising household income and low energy prices should allow robust consumer spending.
- Housing starts and home prices should remain on an upward trend, contributing modestly to overall economic growth.
- Lower oil prices have curbed energy sector fixed investment and hindered growth, particularly in the manufacturing sector, which also faces restraint from weak global demand and the strong dollar. However, manufacturing appears to be stabilizing, with the PMI moving back above 50 in March.
- An inventory correction cycle hurt growth in the second half of 2015, which continued into early 2016. But inventory reduction has shown progress.
- Personal consumption expenditure (PCE) price inflation is being held in check by the strong US dollar, low energy prices and smaller-than-usual increases in healthcare costs. We expect these factors to fade, but inflation is likely to remain below the Federal Reserve's 2% target over the next 12 months.
- Fiscal policy will be slightly positive for growth in FY16, 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.
- The Fed hiked rates by 25 basis points in December 2015 and is likely to gradually raise rates further in 2016.

↗ Positive scenario (Probability: 15%*)

Strong expansion

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

↘ Negative scenario (Probability: 15%*)

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 in 2016.

*Scenario probabilities are based on qualitative assessment.

Key dates

Apr 29	Personal income and spending for March
Apr 29	Employment Cost Index for 1Q16
May 2	ISM manufacturing for April
May 4	ISM non-manufacturing for April

PMIs consistent with moderate growth

Purchasing Manager Indexes



Source: Bloomberg, UBS, as of 18 April 2016

Inflation moving closer to the Fed's 2% target

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



Source: Bloomberg, UBS, as of 18 April 2016

Note: PCE = personal consumption expenditures

Key financial market driver 2 - *Steady Eurozone growth*

Key points

- Economic growth is expected to remain solid despite global hindrances.
- Low oil prices suggest that inflation should remain weak in the spring before rebounding in the summer.
- Following the recent comprehensive easing measures, the ECB is expected to remain on hold and is now in a wait and see mode.

CIO view (Probability: 60%*)

Steady growth

- The Eurozone economy is likely to weather global growth concerns, supported by low oil prices, more fiscal spending on refugees and the strong monetary impulse. Inflation is set to remain weak during the spring due to low oil prices, and to start rising in the summer. In anticipation of such a rebound, the ECB is expected to remain on hold.
- In Germany, fundamentals such as consumer confidence and capital expenditure planning remain robust. The immigration situation is helping the economy grow via greater-than-expected government spending.
- In France, better dynamics in construction are helping solidify growth. Consumption is set to improve, and companies are expected to increase investment spending.
- In the periphery, Italian growth should consolidate supported by its construction sector and more regulatory visibility in its banking sector. Spain, in turn, is posting strong growth. However, 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. France follows a credible reform path and speeds up fiscal consolidation. Political risks fade further.

↘ Negative scenario (Probability: 20%*)

Deflation spiral

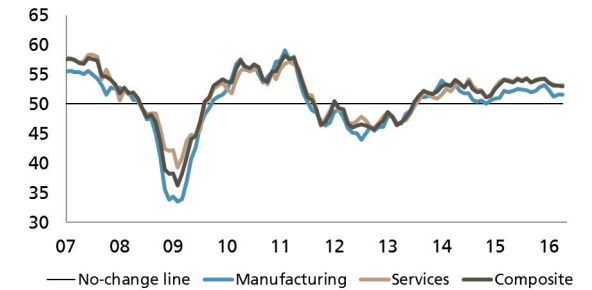
- The Eurozone slips into a deflationary spiral due to a shock, such as Greece leaving the Eurozone, a sharp escalation in the Ukraine conflict, or China suffering a severe economic downturn.

*Scenario probabilities are based on qualitative assessment.

Key dates

Apr 29	HICP inflation (April estimate)
Apr 29	GDP (1Q estimate)
May 12	Industrial production (March)
May 21	Consumer confidence (May estimate)
May 23	Composite PMI (May estimate)

Eurozone composite PMI expected to remain at solid levels

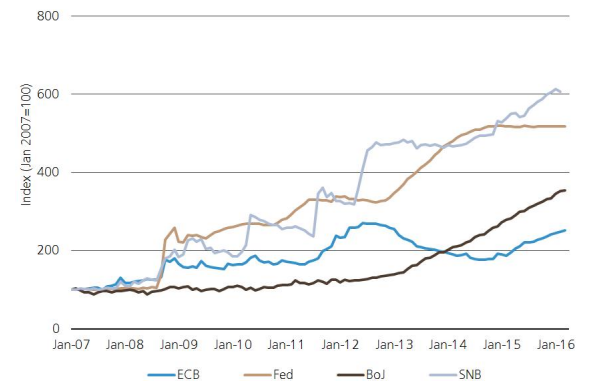


Source: Haver Analytics, UBS, as of April 2016

Note: PMI = purchasing managers' index

ECB balance sheet boosted by QE and TLTROs

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



Source: Haver Analytics, UBS, as of 25 April 2016

Key financial market driver 3 - *Orderly deceleration in China*

Key points

- This year will be a challenging one for China, as growth continues to decelerate amid its economic transformation. China's ability to successfully transform its economy will be decided by deep adjustments in the old manufacturing sector and the development of rising new manufacturing and services sectors.
- Fiscal policy in 2016 will be critical for supporting small and medium-sized firms and in promoting 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 1Q16 GDP growth slid to 6.7% y/y from 6.8% y/y in 4Q15, the weakest quarterly growth since 2009. Deep adjustments in the old economy has placed downward pressure on growth. A slew of macro data such as manufacturing PMI, industrial production, fixed asset investment and retail sales rebounded in March. This was mainly due to a housing boom in tier-1 and tier-2 cities, spurred by excess liquidity, favorable property policies and aggressive mortgage financing rather than real demand. We expect the rebound to normalize in 2Q16, following a gradual cooling in tier-1 property markets after reapplied tightening policies take effect.
- Fiscal policy in 2016 will be critical for 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 (the government's target is 3%), which is about CNY 20trn in fiscal spending.
- Monetary policy will remain accommodative; one more interest rate cut, 300bps to 500bps of reserve requirement ratio (RRR) cuts, as well as aggressive liquidity injections via short and medium-term lending facilities is expected. A priority for monetary policy will be avoiding systematic or regional financial risks, given the worsening credit environment amid the economic slowdown. A CNY 1trn debt-to-equity swap program is expected to be adopted over the three coming years.
- CPI inflation should rise mildly to 1.9% y/y in 2016 mainly due to rising pork prices and a low base. PPI inflation should rebound slightly but remain negative.
- The housing market continues to face downward pressure in 2016 given the inventory overhang in tier-3 and tier-4 cities. The recent fever in tier-1 and tier-2 cities has helped little in resolving 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.

Policy support to moderate slowdown

↗ 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.

Growth acceleration

↘ 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.

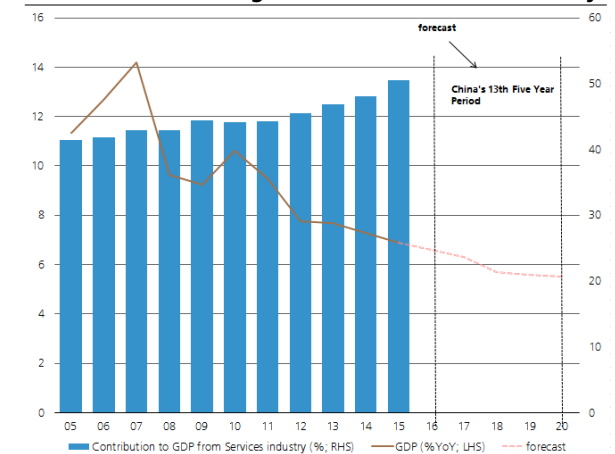
Sharp economic downturn

* Scenario probabilities are based on qualitative assessment.

Key dates

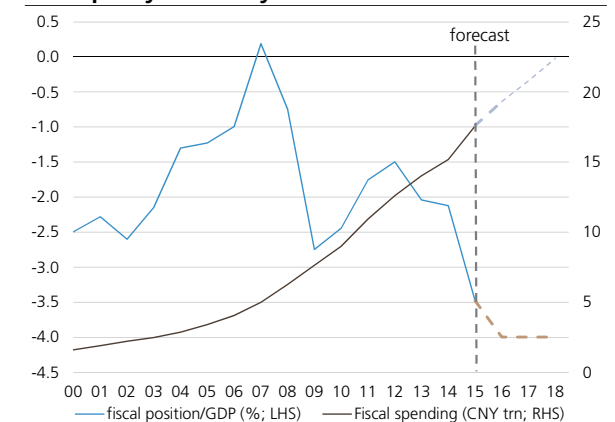
May 8	Trade data for April
May 10-15	Monetary and credit data for April
May 10	CPI, PPI for April
May 14	Industrial production, fixed asset investment, retail sales for April

China is transitioning to a services-driven economy



Source: CEIC, UBS, as of 18 April 2016

Fiscal policy is the key in 2016



Source: CEIC, UBS, as of 18 April 2016

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