

# UBS House View

Monthly Base **August 2016**

**Chief Investment Office WM**

Published  
21 July 2016

This report has been prepared by UBS AG.  
Please see the important disclaimer at the end of the document.  
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.



# Summary

---

"We increase the overweight in US equities as economic strength has been confirmed, while we close the overweight in Euro high yield bonds following the recent rally."

- **Asset allocation**

Concerns about global economic growth have recently been further reduced by strong US data. The US labor market remains resilient, supporting private consumption, as confirmed by strong retail sales. Cuts in capital expenditure in the commodity and manufacturing sectors are bottoming. While the political future of the UK within Europe remains uncertain after the Brexit vote, the issue is a local rather than a global one. China's economy has stabilized around an annual growth rate of 6.5% to 7%, in line with the government's target. There have been further signs of economic stabilization within emerging markets broadly. Central banks remain very accommodative. The ECB will likely extend its quantitative easing program beyond March 2017, while the first rate hike by the US Fed is likely to take place in December 2016 at the earliest. Based on our constructive outlook and expectations for US earnings growth to turn positive in H2 we are increasing our tactical overweight in US equities.

- **Equities**

We are adding to the overweight position in US equities against high grade bonds among further confirmation that the US economy is on a solid footing, while monetary policy remains accommodative. US equities have been resilient so far this year outperforming most other regions, and headwinds to company earnings are fading. We are furthermore opening a tactical overweight in emerging market equities against Swiss stocks. Emerging market economies have shown further signs of bottoming and company earnings are stabilizing. Meanwhile, Swiss financial stocks are facing the headwind of deeply negative interest rates. Investors with exposure to Australian equities should reduce their Australian exposure instead of Swiss equities. Earnings of Australian companies will likely continue their weakness as the currency is turning into a headwind and financials' earnings are likely to come under further pressure due to the easing stance of the central bank and non-accelerating loan growth.

- **Bonds**

Fixed income assets have had a strong run so far this year, supported by both falling government yields and tightening credit spreads. High grade (HG) bond yields have reached new all-time lows, which limits their return outlook over the next 6 months. Euro high yield bonds have reached our spread target. While fundamentals remain intact and ECB policy is a persistent tailwind, price upside from current levels is limited. We are thus closing the overweight position, following good performance year-to-date. Still, we keep strategic exposure to euro HY bonds in our portfolios. We are holding a tactical preference for USD investment grade corporate bonds, offering a yield of 2.3%. While low in a historic context, this still compares favorably to HG bonds.

- **Foreign exchange**

We are maintaining tactical positions in the Norwegian krone over the euro, and in the US dollar over the Australian dollar. The Norwegian economy is showing strong momentum. Consumer price inflation is running at 3.7% and real estate prices are on the rise. This will likely make the central bank increasingly turn away from their dovish stance over the coming months, supporting further appreciation of the currency against the euro. The US economy remains in better shape than the Australian one, corroborating our positive outlook for the USD against the Australian dollar. We expect the Reserve Bank of Australia to strengthen their easing bias in the next months.

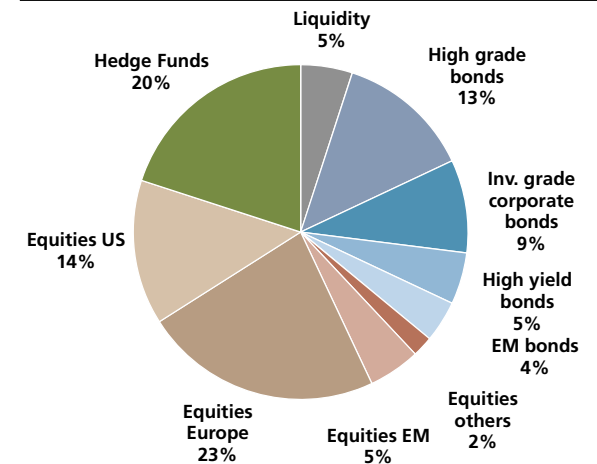
- **Alternative investments and precious metals & commodities**

Following a weak start into the year, diversified hedge fund returns have stabilized in recent months. The asset class should play an important role in portfolios as it provides access to alternative drivers of risks and returns and thus increases the diversification. 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>Emerging markets ( ↗ )</li> <li>Sustainable value creation in EM ( ↗ )</li> <li>Water-linked investments</li> </ul>	<ul style="list-style-type: none"> <li>Switzerland ( ↘ )</li> <li>Australia ( ↘ )</li> </ul>
<b>Bonds</b>	<ul style="list-style-type: none"> <li>US investment grade</li> <li>Rising stars</li> <li>Corporate hybrids</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</b>	<ul style="list-style-type: none"> <li>Event-driven strategies</li> </ul>	
<b>Precious Metals &amp; Commodities</b>		

## Global model portfolio (EUR)



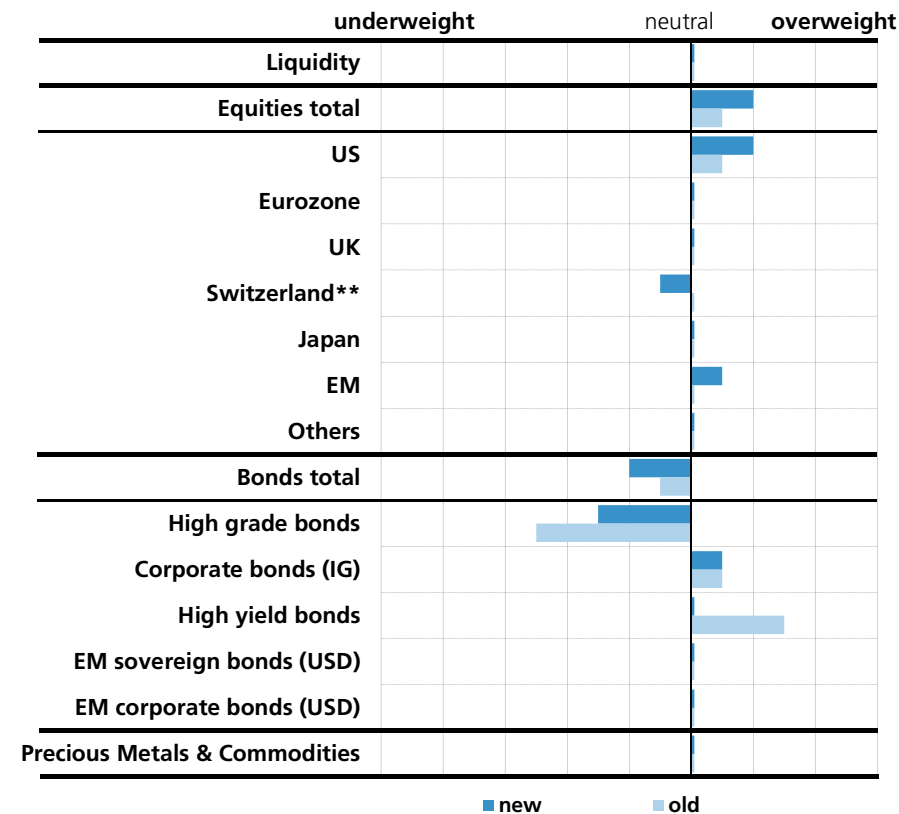
As of 21 July 2016

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\*



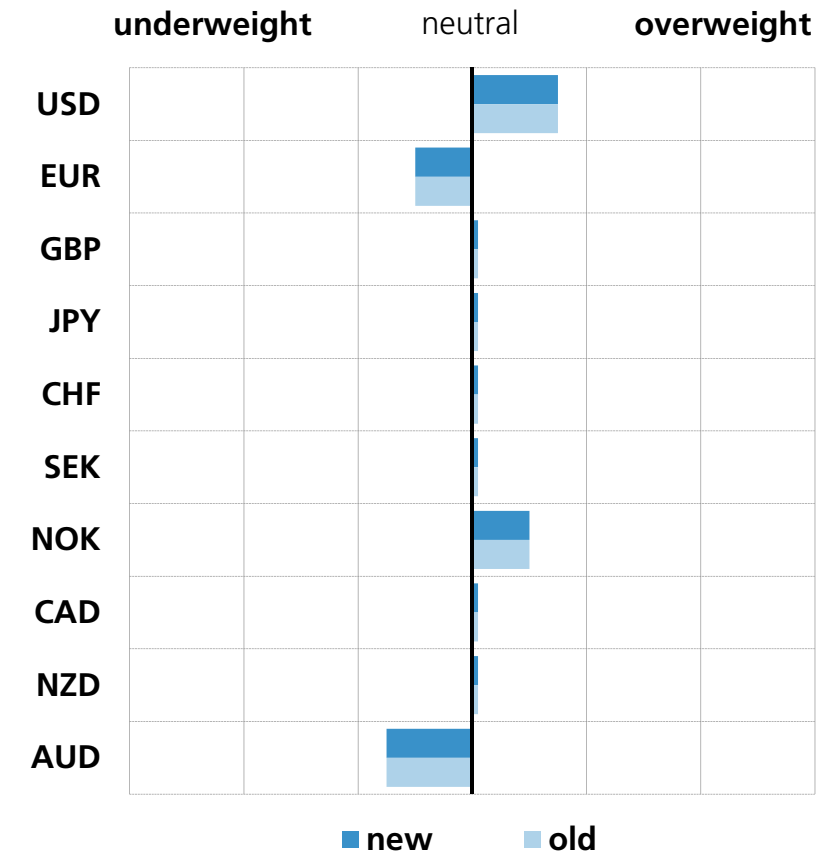
Source: UBS, as of 21 July 2016

\*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.

\*\* Investors with exposure to Australian equities are advised to underweight Australia instead of Switzerland.

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 are generally in good shape: they generate high free cash flow, have plenty of cash on their balance sheets, and enjoy cheap financing costs. The stock market has rewarded investors in companies that return capital through dividends and share buybacks. These companies offer attractive yields in the current low-growth, low-interest environment. On average, S&P 500 companies returning cash to shareholders via dividends and/or share repurchases offer investors a total yield of 5-6% (when combining share buyback and dividend yields). Around two-thirds of this yield come from share buybacks. 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. As buybacks are made at management's discretion, we recommend investing in a diversified basket of stocks.

- **Sustainable value creation in emerging markets**

EM equities offer investors the opportunity to add value to their portfolios by incorporating environmental, social and corporate governance (ESG) considerations into their investment decisions. We argue that the wide disparity among individual companies on ESG performance, in particular with respect to governance issues, necessitates focusing on those with strong management to reduce tail risk events such as severe environmental accidents or weak corporate governance (e.g. accounting/audit issues). As corporate EM governance rules are often less strict than those in developed countries, risks and opportunities are hard to quantify, which suggests that understanding how companies are exposed to ESG risks and opportunities and how they manage them should factor in highly when determining corporate value.

- **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 4.2%, 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.

- **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.

# Key financial market driver 1 - *Central bank policy*

## Key points

- We expect the Federal Reserve to raise rates by 25 basis points in December.
- The ECB is on alert and is closely watching Brexit's impact to see if it needs to ease further.
- The Bank of England left monetary policy unchanged in July, but signaled that it would ease in August.

## CIO view (Probability: 45%)

## Central banks wary of Brexit's impact

- The Brexit vote has little direct impact on the US economy, and so far contagion via financial markets has not been an issue. Recent US data has surprised on the upside, including a strong rise in June nonfarm payrolls. The economy is approaching full employment and inflation is not far from the Fed's 2% target. Uncertainty will likely prevent the Fed from raising rates at the next couple of meetings, but we expect a rate hike in December.
- The ECB is waiting for economic data to show the impact of Brexit on the Eurozone economy. Meanwhile, the inflation rebound that just started remains fully on track. Against this background, the impact on the economy needs to be more than moderate for the ECB to introduce further substantial monetary easing. For now, we expect the ECB to extend its QE program with EUR 80bn or less beyond the current QE end date of March 2017.
- At its first meeting after the Brexit vote, the Bank of England signaled its intention to ease monetary policy in August. We expect rates to be cut to zero by the end of the year, with the possibility of additional quantitative measures. The Swiss National Bank continues to struggle against deflationary forces. We expect it to keep rates deeply negative for at least another 12 months. Japan's economy is struggling and inflation has turned negative. The Bank of Japan is therefore likely to add to its already aggressive monetary easing.

## ➤ Positive scenario (Probability: 40%)

## Worse macro backdrop

- The Fed is forced to stay on hold, but a rate cut remains unlikely. The ECB launches additional monetary easing rapidly to address the downside risks emanating from the UK referendum. This may include more QE, a deposit rate cut, etc.

## ⚡ Negative scenario (Probability: 15%)

## Macro risks fade

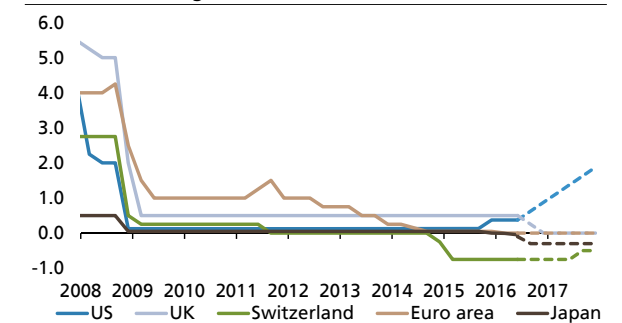
- Diminished risks allow the Fed to hike rates twice by year-end. The ECB ignores the fallout from Brexit and changes its focus rapidly to the inflation rebound, signaling a full exit from its QE program.

## Key dates

Jul 22	Eurozone PMIs for July
Jul 27	FOMC meeting
Jul 29	US GDP for 2Q16

## Central bank policy to diverge

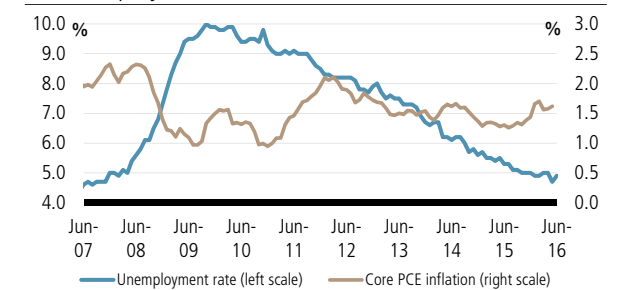
Central bank target rates and UBS forecasts, in %



Bloomberg, UBS, as of 14 July 2016

## Fed close to fulfilling its dual mandate

US unemployment rate and core PCE inflation



Bloomberg, UBS, as of 14 July 2016

# Key financial market driver 2 - *Crude oil market rebalancing*

## Key points

- The journey from an oversupplied to a sustainably balanced oil market is in full swing. The oil market has to absorb the return of large amounts of disrupted oil, which is likely to pressure prices lower in the short run.
- Unless there is a short-term setback, contracting non-OPEC production and rising oil demand in emerging markets should result in a balanced oil market in 2017.
- Crude oil prices around USD 40/bbl offer investors the opportunity to increase medium- to longer-term exposure to the oil market.

## CIO view (Probability: 70%)

- Rebalancing of the oil market is well under way, and still has some way to go, considering higher OPEC output and the return of disrupted supply. Also, demand concerns have not abated due to the UK vote and weak Chinese leading indicators. These factors, together with elevated speculative long positions in the crude oil futures market, suggest the risk-reward of holding an outright long exposure is not attractive. In the short run, we expect prices to fall back towards USD 40/bbl.
- Still, contracting non-OPEC supply and rising demand should result in a balanced oil market in 2017. Cuts in capital spending worldwide of 24% last year and another 20% likely this year should result in non-OPEC supply falling 0.8mbpd this year – the first contraction since 2008. Production in non-OPEC nations is likely to contract in 2017 as well. Meanwhile, global demand should rise 1.2mbpd this year, slightly above the 10-year average annual growth rate, and low prices should still support demand growth. For next year, we forecast oil demand will grow by about 1mbpd, with higher prices limiting demand growth.
- For oil prices, short-term setbacks are unlikely to last over a 6-12 month horizon. Over 12 months, we expect Brent prices to trade at USD 55/bbl. This offers investors an opportunity to build medium- to longer-term exposure to the oil market after a likely near-term correction.

## ➤ Positive scenario (Probability: 10-20%)

- Along with geopolitical events, political destabilization in oil exporting countries like Venezuela or those in the Middle East, and/or an emergency OPEC meeting that leads to a production cut are factors to consider. Alternatively, US crude oil production could contract more sharply than projected by key energy agencies.

## ⚡ Negative scenario (Probability: 10%)

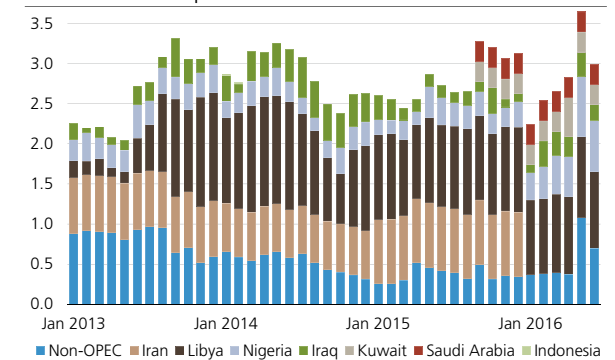
- Cost reductions, efficiency gains and industry consolidation could lead to more resilient US oil production, keeping the oil market oversupplied and inventories on the rise – potentially reaching storage capacity limits. Also, receding unplanned crude production outages in OPEC countries (like in Libya) could exacerbate the short-term production surplus.

## Key dates

<b>Jul 29</b>	US oil supply and demand data for May
<b>Aug 9</b>	EIA short-term energy outlook, providing global demand and supply data
<b>Aug 11</b>	IEA oil market report, providing global demand and supply data
<b>Nov 23</b>	OPEC's ordinary meeting in Vienna

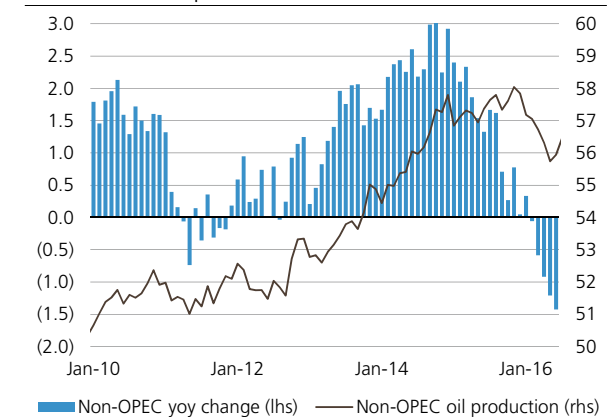
## Unplanned production outages have declined from record levels

Values are in mbpd



## Non-OPEC supply is already contracting

Values are in mbpd





# Key financial market driver 3 - *US earnings growth to resume*

## Key points

- We expect S&P 500 EPS to rebound to positive growth in 2H16 and 2017.
- The earnings headwinds from depressed oil prices and the strong dollar are fading.
- High profit margins can be sustained until the next recession.

## CIO view (Probability: 60%)

### Core trends improving

- While headline 2Q16 S&P 500 EPS will likely be flat to slightly down year-on-year (down 0-2%), results should compare favorably to the 6% profit decline experienced in the first quarter. This improving trend should continue with S&P 500 earnings growth turning positive in the second half of the year.
- The huge drag on profits from the strong US dollar and poor energy sector results has largely run its course. Keep in mind that excluding the energy sector, 1Q16 was the only quarter over the past two years with negative year-on-year earnings. S&P 500 EPS ex-energy is likely to show 2-4% growth in 2Q16.
- With US economic momentum improving – the ISM manufacturing index is at a 16-month high and consumer spending is accelerating – earnings trends excluding the distortions from the energy sector and the dollar should brighten as US and global economic growth remains resilient.
- We look for stable profit margins over the next several quarters and expect a moderate acceleration in revenue growth to drive the anticipated earnings rebound.
- CIO forecasts 2016 and 2017 S&P 500 EPS of USD 122 (+3%) and USD 130 (+7%), respectively.

## ↗ Positive scenario (Probability: 20%)

### Business confidence accelerates

- Higher interest rates and rising commodity prices driven by improving global growth prospects could produce stronger-than-anticipated S&P 500 EPS growth as energy and financials - roughly 25% of S&P 500 profits - could see a meaningful profit improvement. Increased confidence in the global economic expansion could spur greater enterprise spending and capital investment, improving the outlook for the technology and the industrial sectors. Regardless of the outcome of the November presidential election, momentum towards tax reform will likely build. Lower taxation on repatriated foreign earnings could boost S&P 500 EPS via higher share buybacks.

## ↘ Negative scenario (Probability: 20%)

### Growth slump or stagflation

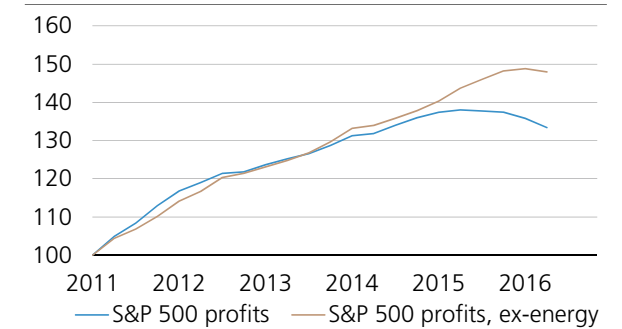
- A downturn in US and global growth could lead to weaker-than-projected revenues for S&P 500 companies. Wage pressures unaccompanied by improving consumer and business demand could pressure profit margins and earnings growth rates. Persistently low short-term interest rates and continued declines in long-term interest rates could pressure financial sector earnings.

## Key dates

**Aug 12** 2Q16 earnings season would mostly be over

## Earnings weakness mostly energy related

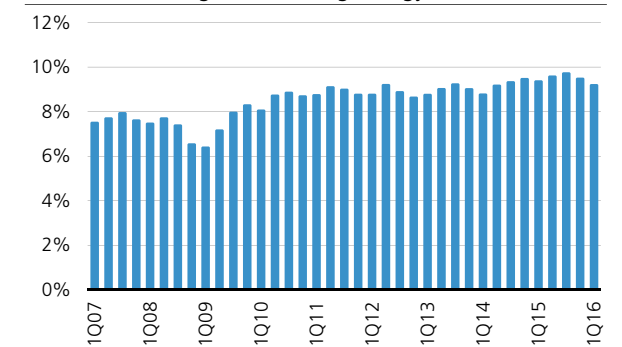
S&P 500 profits, aggregate and excluding the energy sector, indexed to 100 (as of 2011)



FactSet and UBS, as of 14 July 2016

## Core profit margins have been fairly stable

S&P 500 net margins, excluding energy and financials



FactSet and UBS, as of 14 July 2016

# Global economic outlook - *Summary*

## Key points

- We expect global growth to vary. The US is growing at a moderate pace. Emerging markets should stabilize at lackluster levels.
- The policies of major central banks are expected to diverge. We expect the Fed to raise rates toward the year-end, and the ECB to closely monitor Brexit spillover effects and act if needed.
- We believe inflation will remain subdued globally even if divergences among countries increase.

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

### Stable world growth in 2016

- We expect global economic growth to hold up this year, with most developed nations faring well and emerging markets (EMs) stabilizing at lackluster levels relative to their historical growth rates. EM growth should improve in 2017.
- We expect moderate US economic growth. In the Eurozone, sound domestic fundamentals should limit negative spillovers from Brexit. Within EMs, 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 relatively subdued growth is expected to restrain inflation in emerging markets.
- We expect the Fed to raise rates toward the end of the year, but policy should remain accommodative. The Bank of Japan should continue with its expansive monetary policy. The ECB is vigilant and ready to act if needed following the UK referendum.

## ↗ 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.
- Emerging markets are able to attract capital inflows due to credible reform measures and improving growth prospects. 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.
- China's 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>Jul 27</b>	US: FOMC monetary policy meeting
<b>Jul 29</b>	Japan: BoJ monetary policy meeting
<b>Jul 29</b>	US: GDP (2Q)
<b>Jul 29</b>	Eurozone: GDP (2Q)
<b>Aug 1</b>	China: Manufacturing PMI (July)

## Global growth broadly stable in 2016

		Real GDP growth in %			Inflation in %		
		2015	2016F	2017F	2015	2016F	2017F
<b>Americas</b>	US	2.4	1.7	2.3	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	2.7	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	5.2	4.2
<b>Europe</b>	Eurozone	1.6	1.5	1.3	0.0	0.3	1.8
	UK	2.3	1.3	0.5	0.0	0.8	3.4
	Switzerland	0.8	0.9	1.3	-1.1	-0.3	0.4
	Russia	-3.7	-0.6	1.5	15.5	7.1	5.0
<b>World</b>		3.2	3.0	3.3	2.7	2.7	2.8

Source: UBS, as of 18 July 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 June 2016

# US economy - *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.
- We expect the Fed to raise rates by 25 basis points in December.

## CIO view (Probability: 70%\*)

### Moderate expansion

- We expect the US economy 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 in oil prices. The manufacturing sector has been restrained by weak global demand and the strong US 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 should gradually trend higher.
- 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.
- With progress being made toward the Fed's dual mandate of full employment and price stability, we expect a 25 basis point rate hike in December.

## ➤ 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: 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 this year.

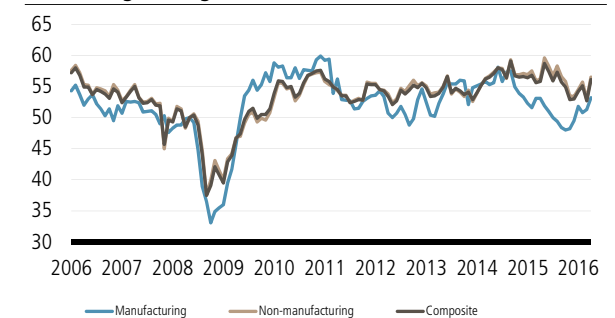
\*Scenario probabilities are based on qualitative assessment.

## Key dates

Jul 27	FOMC rate decision
Jul 29	GDP for 2Q
Aug 1	ISM manufacturing for July
Aug 2	PCE deflator for June

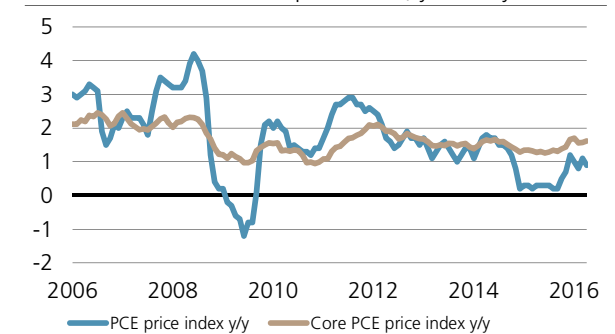
## PMIs consistent with moderate growth

### Purchasing managers' indices



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

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



# Eurozone economy - *Solid Eurozone growth*

## Key points

- We expect economic growth to remain solid despite global hindrances and the UK vote to leave the EU.
- Inflation should start to rebound in the summer for several quarters.
- The ECB is closely monitoring Brexit spillovers and would intervene if needed.

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

### Solid growth

- We expect the Eurozone economy to weather growth concerns thanks to a positive fiscal stance and a strong monetary impulse, allowing it to limit the negative impact of the UK referendum over the coming quarters. Inflation is set to start rising in the summer through early next year. The ECB is in wait-and-see mode. It is closely monitoring the fallout of the UK referendum on the economy and inflation, and ready to act if needed.
- 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 the construction sector. Spain, in turn, is still posting strong growth. But this should moderate given the uncertain political situation and upcoming 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

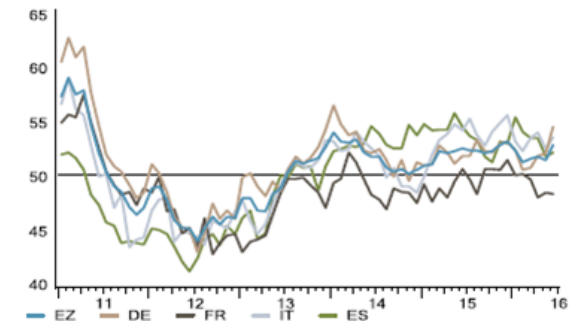
- The Eurozone slips into a deflationary spiral due to a shock, such as Greece leaving the Eurozone, a sharp escalation in the Ukraine conflict or China suffering a severe economic downturn.

\*Scenario probabilities are based on qualitative assessment.

## Key dates

Jul 22	Markit PMIs (July)
Jul 29	CPI estimate (July)
Jul 29	GDP (2Q)
Aug 12	Industrial production (June)

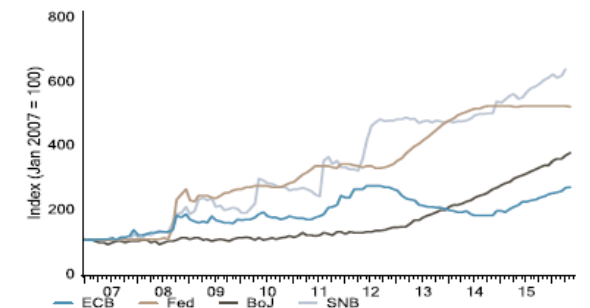
## Eurozone PMIs expected to remain solid



Source: Haver Analytics, UBS, as of June 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, data, as of June 2016 (SNB, as of May 2016)

# Chinese economy - *China's orderly deceleration*

## Key points

- China is striking a balance between economic stability and mild reforms.
- Fiscal policy is more critical in supporting small- and medium-sized enterprises and new manufacturing sectors.
- Fiscal and monetary policies are to remain accommodative to avoid a hard landing and a financial crisis.

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

## Policy support to moderate economic slowdown

- China's 2Q16 GDP growth held steady at 6.7% y/y in 2Q16, remaining the weakest quarterly growth since the 2009 global recession. China's growth continued to face downward pressure amid deep adjustment in the old economy. 1H16 fixed asset investment (FAI) growth slowed sharply to 9.0% y/y from 10.0% in 2015, dragged down by FAI manufacturing and real estate. Notably, private investment growth plunged to 2.8% y/y in 1H16 from 10.1% in 2015. 1H16 retail sales growth edged down to 10.3% y/y from 10.7% in 2015. 1H16 exports fell 7.0% y/y after a 3% drop in 2015 on weaker external demand; import growth shrank 10% y/y after contracting 14% in 2015 due to weaker growth and lower commodity prices. As a whole, we expect an orderly deceleration with a prolonged "L-shaped" economy amid a balance between economic stability and mild reforms.
- Fiscal policy this year is expected to play a more critical role in supporting small- and medium-sized firms, promoting new manufacturing sectors, and resolving overcapacities. 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 medium/long-term lending facilities. A priority for monetary policy will be avoiding systematic financial risks, given the worsening credit environment amid the economic slowdown. The possibility of reserve requirement ratio (RRR) cuts has increased after the weak economic growth in 1H16.
- CPI inflation is expected to rise mildly this year, mainly due to higher pork prices and a low base. June and 2Q CPI inflation was 1.9% and 2.1%, respectively. The June PPI fell by 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 in the broad market. 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%\*)

## Growth acceleration

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

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

## Sharp economic downturn

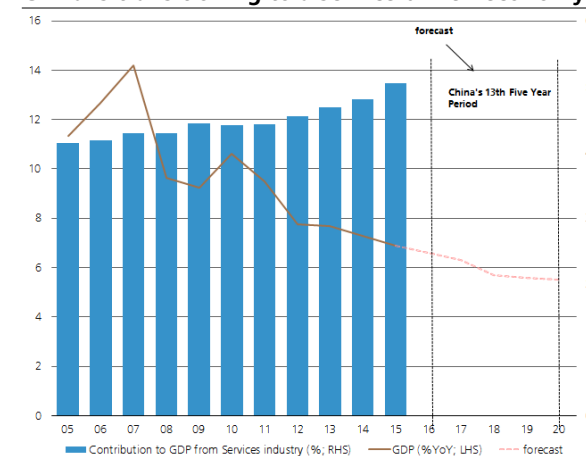
- A hard landing materializes, which we define as sub-5% real GDP growth for more than two quarters. The economy weakens abruptly due to a sharper downturn in property investment and widespread credit events.

\* Scenario probabilities are based on qualitative assessment.

## Key dates

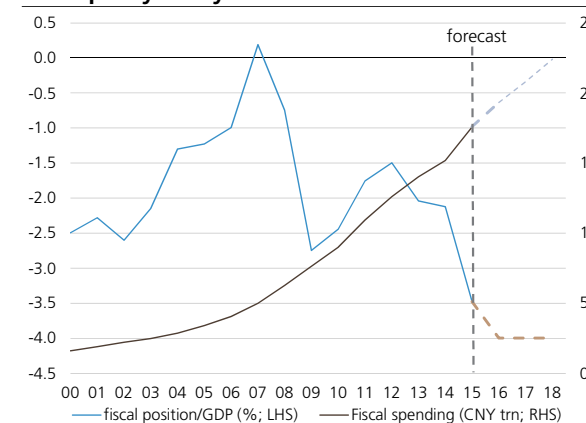
<b>Aug 7-8</b>	Trade data for July
<b>Aug 8</b>	CPI, PPI inflation for July
<b>Aug 9-15</b>	Monetary and credit data for July
<b>Aug 11</b>	Industrial production, fixed asset investment, retail sales for July

## China is transitioning to a service-driven economy



Source: CEIC, UBS, as of 15 July 2016

## Fiscal policy is key in 2016



Source: CEIC, UBS, as of 15 July 2016

# Swiss economy - *Recovery in an uncertain environment*

## Key points

- The Swiss economy should gradually recover in 2H16 as exporters learn to live with the strong Swiss franc.
- The UK's decision to leave the EU has sharply increased economic uncertainty and may hurt Swiss economic growth by slowing demand for Swiss products in Europe.
- The Swiss National Bank (SNB) will try to prevent a sharp appreciation of the franc by intervening in the FX market and by cutting the benchmark rate if intervention volumes to support EURCHF become unsustainable.

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

### Moderate recovery despite Brexit

- The Swiss economy grew 0.1% in 1Q16, supported by private consumption, investments and exports. However, an inventory correction hurt activity.
- Swiss companies are learning to live with the strong Swiss franc but the adjustment process is painful – and is likely to result in the GDP growing just 0.9% in 2016. Growth will only approach its potential of 1.50-1.75% in 2017 when Swiss exporters have completely adapted to the strong franc.
- The Swiss manufacturing PMI pointed to a swift rebound of the Swiss economy before the UK exit vote. Even after the sharp setback seen in June the PMI still hints at a recovery – albeit only a gradual one.
- CPI inflation has rebounded lately but remained in negative territory in 2Q16. Inflation is expected to gradually creep back into positive territory in the coming quarters as the effects of weaker oil prices and the stronger franc are fading.
- The SNB's main goal in the short term is to prevent a sharp appreciation of the franc in order to safeguard the fragile economic recovery. To achieve this goal, the SNB would first intervene in the FX market. Only if intervention volumes to support EURCHF become unsustainable would the SNB resort to a further rate cut. A rate hike is not on the cards in the next 12 months. The SNB will have the opportunity to make a first rate move only after the ECB has stopped its QE program.
- The initiative against mass immigration has to be implemented by February 2017. But as the EU has to deal with UK-related problems, Switzerland is unlikely to negotiate an acceptable solution with the EU by February 2017. This reduces the political leeway considerably and raises the risk of a new popular vote on this issue (which could also include bilateral treaties).

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

### Brexit has no impact

- Export growth gathers momentum in 2H16 and in 2017 as the UK exit has less impact on the real economy than feared.

## ↘ Negative scenario (Probability: 20%\*)

### Swiss economy stagnates in 2H16

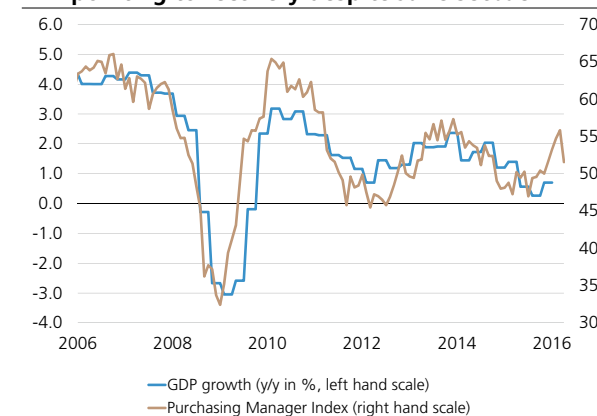
- Swiss recovery stalls as demand from Europe falls off the cliff due to strong displacements in European financial markets as well as in the real economy.

\* Scenario probabilities are based on qualitative assessment.

## Key dates

<b>Jul 27</b>	UBS Consumption Indicator for June
<b>Aug 2</b>	PMI manufacturing for July
<b>Aug 3</b>	UBS Real Estate Bubble Index (2Q16)
<b>Aug 7</b>	Unemployment rate for July
<b>Aug 8</b>	Consumer prices for July

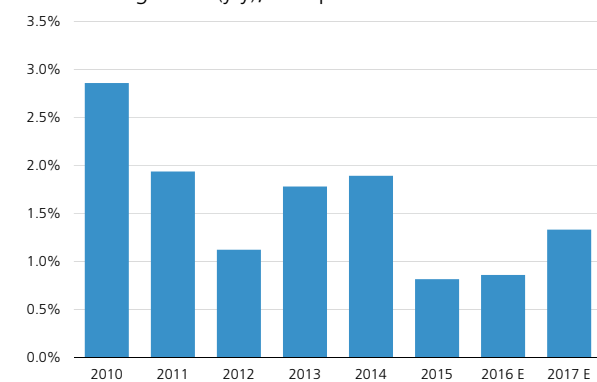
## PMI pointing to recovery despite June setback



Source: procure.ch, UBS

## Swiss GDP growth improves only gradually

Swiss GDP growth (y/y), E: Expectations



Source: Seco, UBS

# Contact list

---

## **Global Chief Investment Officer WM**

Mark Haefele  
[mark.haefele@ubs.com](mailto:mark.haefele@ubs.com)

## **UBS CIO WM Global Investment Office**

### **Regional Asset Allocation**

Mark Andersen  
[mark.andersen@ubs.com](mailto:mark.andersen@ubs.com)

### **Global Asset Allocation**

Mads Pedersen  
[mads.pedersen@ubs.com](mailto:mads.pedersen@ubs.com)

### **UHNW & Alternatives IO**

Simon Smiles  
[simon.smiles@ubs.com](mailto:simon.smiles@ubs.com)

### **Investment Themes**

Philippe G. Müller  
[philippe-g.mueller@ubs.com](mailto:philippe-g.mueller@ubs.com)

## **UBS CIO WM Regional Chief Investment Offices**

### **US**

Mike Ryan  
[mike.ryan@ubs.com](mailto:mike.ryan@ubs.com)

### **APAC**

Min Lan Tan  
[min-lan.tan@ubs.com](mailto:min-lan.tan@ubs.com)

### **Europe**

Themis Themistocleous  
[themis.themistocleous@ubs.com](mailto:themis.themistocleous@ubs.com)

### **Switzerland**

Daniel Kalt  
[daniel.kalt@ubs.com](mailto:daniel.kalt@ubs.com)

# Disclaimer

UBS Chief Investment Office WM's investment views are prepared and published by Wealth Management and Retail & Corporate or Wealth Management Americas, Business Divisions of UBS AG (regulated by FINMA in Switzerland), its subsidiary or affiliate ("UBS"). In certain countries UBS AG is referred to as UBS SA. This material is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this material were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS). All information and opinions as well as any prices indicated are current as of the date of this report, and are subject to change without notice. The market prices provided in performance charts and tables are closing prices on the respective principal stock exchange. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria. UBS and any of its directors or employees may be entitled at any time to hold long or short positions in investment instruments referred to herein, carry out transactions involving relevant investment instruments in the capacity of principal or agent, or provide any other services or have officers, who serve as directors, either to/for the issuer, the investment instrument itself or to/for any company commercially or financially affiliated to such issuers. At any time, investment decisions (including whether to buy, sell or hold securities) made by UBS and its employees may differ from or be contrary to the opinions expressed in UBS research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and Options trading is not suitable for every investor as there is a substantial risk of loss, and losses in excess of an initial investment may occur. Past performance of an investment is no guarantee for its future performance. Additional information will be made available upon request. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. Tax treatment depends on the individual circumstances and may be subject to change in the future. UBS does not provide legal or tax advice and makes no representations as to the tax treatment of assets or the investment returns thereon both in general or with reference to specific client's circumstances and needs. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we would recommend that you take financial and/or tax advice as to the implications (including tax) of investing in any of the products mentioned herein. This material may not be reproduced or copied circulated without prior authority of UBS. UBS expressly prohibits the distribution and transfer of this material to third parties for any reason. UBS accepts no liability whatsoever for any claims or lawsuits from any third parties arising from the use or distribution of this material. This report is for distribution only under such circumstances as may be permitted by applicable law. In developing the Chief Investment Office (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. For information on the ways in which UBS CIO WM manages conflicts and maintains independence of its investment views and publication offering, and research and rating methodologies, please visit [www.ubs.com/research](http://www.ubs.com/research). Additional information on the relevant authors of this publication and other CIO publication(s) referenced in this report; and copies of any past reports on this topic; are available upon request from your client advisor.

**External Asset Managers / External Financial Consultants:** In case this research or publication is provided to an External Asset Manager or an External Financial Consultant, UBS expressly prohibits that it is redistributed by the External Asset Manager or the External Financial Consultant and is made available to their clients and/or third parties. **Australia:** This notice is issued by UBS AG ABN 47 088 129 613 (Holder of Australian Financial Services Licence No 231087): This Document is issued and distributed by UBS AG. This is the case despite anything to the contrary in the Document. The Document is intended for use only by "Wholesale Clients" as defined in section 761G ("Wholesale Clients") of the Corporations Act 2001 (Cth) ("Corporations Act"). In no circumstances may the Document be made available by UBS AG to a "Retail Client" as defined in section 761G of the Corporations Act. UBS AG's research services are only available to Wholesale Clients. The Document is general information only and does not take into account any person's investment objectives, financial and taxation situation or particular needs. **Bahamas:** This publication is distributed to private clients of UBS (Bahamas) Ltd and is not intended for distribution to persons designated as a Bahamian citizen or resident under the Bahamas Exchange Control Regulations. **Bahrain:** UBS is a Swiss bank not licensed, supervised or regulated in Bahrain by the Central Bank of Bahrain and does not undertake banking or investment business activities in Bahrain. Therefore, Clients have no protection under local banking and investment services laws and regulations. **Brazil:** Prepared by UBS Brasil Administradora de Valores Mobiliários Ltda, entity regulated by Comissão de Valores Mobiliários ("CVM"). **Canada:** In Canada, this publication is distributed to clients of UBS Wealth Management Canada by UBS Investment Management Canada Inc.. **France:** This publication is distributed by UBS (France) S.A., French "société anonyme" with share capital of € 125.726.944, 69, boulevard Haussmann F-75008 Paris, R.C.S. Paris B 421 255 670, to its clients and prospects. UBS (France) S.A. is a provider of investment services duly authorized according to the terms of the "Code Monétaire et Financier", regulated by French banking and financial authorities as the "Autorité de Contrôle Prudentiel et de Résolution". **Germany:** The issuer under German Law is UBS Deutschland AG, Bockenheimer Landstrasse 2-4, 60306 Frankfurt am Main. UBS Deutschland AG is authorized and regulated by the "Bundesanstalt für Finanzdienstleistungsaufsicht". **Hong Kong:** This publication is distributed to clients of UBS AG Hong Kong Branch by UBS AG Hong Kong Branch, a licensed bank under the Hong Kong Banking Ordinance and a registered institution under the Securities and Futures Ordinance. **India:** Distributed by UBS Securities India Private Ltd. 2/F, 2 North Avenue, Maker Maxity, Bandra Kurla Complex, Bandra (East), Mumbai (India) 400051. Phone: +912261556000. SEBI Registration Numbers: NSE (Capital Market Segment): INB230951431, NSE (F&O Segment) INF230951431, BSE (Capital Market Segment) INB010951437. **Indonesia:** This research or publication is not intended and not prepared for purposes of public offering of securities under the Indonesian Capital Market Law and its implementing regulations. Securities mentioned in this material have not been, and will not be, registered under the Indonesian Capital Market Law and Regulations. **Israel:** UBS Switzerland AG is registered as a Foreign Dealer in cooperation with UBS Wealth Management Israel Ltd, a wholly owned UBS subsidiary. UBS Wealth Management Israel Ltd is a licensed Portfolio Manager which engages also in Investment Marketing and is regulated by the Israel Securities Authority. This publication shall not replace any investment advice and/or investment marketing provided by a relevant licensee which is adjusted to your personal needs. **Italy:** This publication is distributed to the clients of UBS (Italia) S.p.A., via del vecchio politecnico 3, Milano, an Italian bank duly authorized by Bank of Italy to the provision of financial services and supervised by "Consob" and Bank of Italy. **Jersey:** UBS AG, Jersey Branch, is regulated and authorized by the Jersey Financial Services Commission for the conduct of banking, funds and investment business. **Luxembourg:** This publication is not intended to constitute a public offer under Luxembourg law, but might be made available for information purposes to clients of UBS (Luxembourg) S.A., 33A avenue J.F. Kennedy, L-1855 Luxembourg, R.C.S. Luxembourg B 11142, a regulated bank under the joint supervision of the European Central bank and the "Commission de Surveillance du Secteur Financier" (CSSF), to which this publication has not been submitted for approval. **Mexico:** This document has been distributed by UBS Asesores México, S.A. de C.V., a company which is not part of UBS Grupo Financiero, S.A. de C.V. or of any other Mexican financial group and whose obligations are not guaranteed by any third party. UBS Asesores México, S.A. de C.V. does not guarantee any yield whatsoever. **Netherlands:** This publication is not intended to constitute a public offering or a comparable solicitation under Dutch law, but might be made available for information purposes to clients of UBS Bank (Netherlands) B.V., a regulated bank under the supervision of "De Nederlandsche Bank" (DNB) and "Autoriteit Financiële Markten" (AFM), to which this publication has not been submitted for approval. **New Zealand:** This notice is distributed to clients of UBS Wealth Management Australia Limited ABN 50 005 311 937 (Holder of Australian Financial Services Licence No. 231127), Chifley Tower, 2 Chifley Square, Sydney, New South Wales, NSW 2000, by UBS Wealth Management Australia Ltd. You are being provided with this UBS publication or material because you have indicated to UBS that you are a client certified as a wholesale investor and/or an eligible investor ("Certified Client") located in New Zealand. This publication or material is not intended for clients who are not Certified Clients ("Non-Certified Clients"), and if you are a Non-Certified Client you must not rely on this publication or material. If despite this warning you nevertheless rely on this publication or material, you hereby (i) acknowledge that you may not rely on the content of this publication or material and that any recommendations or opinions in this publication or material are not made or provided to you, and (ii) to the maximum extent permitted by law (a) indemnify UBS and its associates or related entities (and their respective directors, officers, agents and advisers (each a "Relevant Person") for any loss, damage, liability or claim any of them may incur or suffer as a result of, or in connection with, your unauthorised reliance on this publication or material and (b) waive any rights or remedies you may have against any Relevant Person for (or in respect of) any loss, damage, liability or claim you may incur or suffer as a result of, or in connection with, your unauthorised reliance on this publication or material. **Saudi Arabia:** This publication has been approved by UBS Saudi Arabia (a subsidiary of UBS AG), a Saudi Arabian closed joint stock company incorporated in the Kingdom of Saudi Arabia under commercial register number 1010257812 having its registered office at Tawteer Towers, P.O. Box 75724, Riyadh 11588, Kingdom of Saudi Arabia. UBS Saudi Arabia is authorized and regulated by the Capital Market Authority of Saudi Arabia. **Singapore:** Please contact UBS AG Singapore branch, an exempt financial adviser under the Singapore Financial Advisers Act (Cap. 110) and a wholesale bank licensed under the Singapore Banking Act (Cap. 19) regulated by the Monetary Authority of Singapore, in respect of any matters arising from, or in connection with, the analysis or report. **Spain:** This publication is distributed to clients of UBS Bank, S.A. by UBS Bank, S.A., a bank registered with the Bank of Spain. **Taiwan:** This material is provided by UBS AG, Taipei Branch in accordance with laws of Taiwan, in agreement with or at the request of clients/prospects. **UAE:** This research report is not intended to constitute an offer, sale or delivery of shares or other securities under the laws of the United Arab Emirates (UAE). The contents of this report have not been and will not be approved by any authority in the United Arab Emirates including the UAE Central Bank or Dubai Financial Authorities, the Emirates Securities and Commodities Authority, the Dubai Financial Market, the Abu Dhabi Securities market or any other UAE exchange. This material is intended for professional clients only. UBS AG Dubai Branch is regulated by the DFSA in the DFC. UBS AG/UBS Switzerland AG is not licensed to provide banking services in the UAE by the Central Bank of the UAE nor is it licensed by the UAE Securities and Commodities Authority. The UBS AG Representative Office in Abu Dhabi is licensed by the Central Bank of the UAE to operate a representative office. **UK:** Approved by UBS AG, authorised and regulated by the Financial Market Supervisory Authority in Switzerland. In the United Kingdom, UBS AG is authorised by the Prudential Regulation Authority and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. A member of the London Stock Exchange. This publication is distributed to private clients of UBS London in the UK. Where products or services are provided from outside the UK, they will not be covered by the UK regulatory regime or the Financial Services Compensation Scheme. **USA:** This document is not intended for distribution into the US, and / or to US persons, or by US-based UBS personnel. UBS Securities LLC is a subsidiary of UBS AG and an affiliate of UBS Financial Services Inc., UBS Financial Services Inc. is a subsidiary of UBS AG.

Version 06/2016.

©UBS 2016. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.