

UBS House View

Monthly Base **February 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.

Published
21 January 2016



Summary

"Global uncertainty has risen in recent months and we recommend a neutral allocation to global equities. Still, we believe Eurozone companies are best positioned to benefit from a continued domestic recovery"

- **Economy**

China has once again taken center stage in early 2016 as its government's currency management raised uncertainty about the future path and degree of RMB depreciation among global investors. While the risk of global contagion has risen, our base case remains for China avoiding an economic "hard landing". More importantly, we expect continued growth in the US and Eurozone, balancing the general growth weakness of emerging markets (EM). The US Fed kicked off the rate hiking cycle on December 16th. This happens against the backdrop of a robust labor market, as highlighted by strong new job creation in December. Still, this hiking cycle will progress only very gradually due to low inflation and the prevalent weakness in parts of the economy, namely manufacturing. Meanwhile, Eurozone growth continues apace. Latest leading indicators showed a further mild improvement in the outlook. Still, at persistently low inflation levels more ECB easing is becoming more likely.

- **Equities**

Against a backdrop of volatile markets susceptible to otherwise manageable negative shocks as well as the uncertainty over the Chinese government's currency management intentions, we recommend a neutral position in global equities in our tactical asset allocation. However, we believe Eurozone companies are currently best positioned to benefit from continued global demand. Low refinancing costs and a supportive currency effect should additionally support rising profitability. Therefore, we prefer Eurozone over UK and EM equities in a regional context. UK equities have a large exposure to the energy and the materials sectors, where the latest rout in commodity prices weighs, while EM equities earnings and profit margins continue to deteriorate against a backdrop of weak domestic fundamentals.

- **Bonds**

We maintain an overweight in euro high yield (HY) bonds. The asset class held up relatively well so far this year, despite the market turmoil. At an average yield to maturity of 6.4% euro HY bonds offer an appealing yield pickup over "safer" bonds. At the same time, the credit quality of euro HY is relatively good, with 64% of the index rated BB. The euro HY index has a relatively small exposure to the energy sector of around 6%, and default rates are expected to remain below 2% through 2016. From current low yield levels, high grade bonds are unlikely to deliver attractive total returns over the next 6 months. We are underweight the asset class. But high grade bonds continue to play a crucial role as portfolio diversifier, stabilizing portfolio returns when risk assets sell off.

- **Foreign exchange**

We maintain our overweight position in the Norwegian krone against the euro. A stabilizing Norwegian economy should lead to monetary policy divergence and support a rising yield differential in favor of the krone. We are adding an underweight position in the Japanese yen against the US dollar. The yen strengthened amid the recent global risk off sentiment, thereby making it even more difficult for the Bank of Japan to reach its inflation target. The BoJ is hence expected to at least maintain, if not expand, its very easy monetary policy stance. The US Fed, on the other hand, has embarked on a path of gradual policy tightening. For EURUSD, we maintain our 6-month and 12-month forecasts of 1.08 and 1.10, respectively.

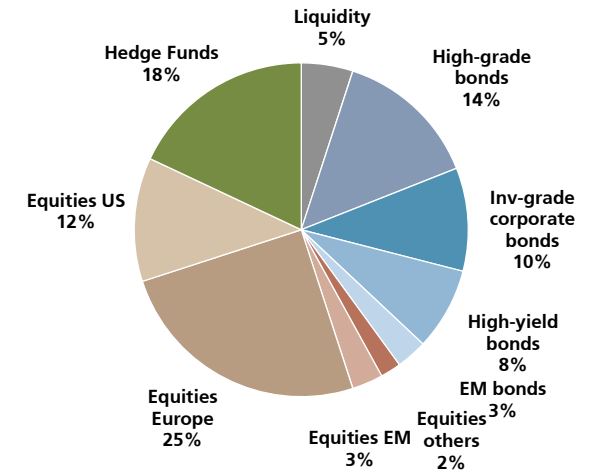
- **Alternative investments and precious metals & commodities**

For the third year running, we maintain a zero allocation to commodities as an asset class in our asset allocations. Global commodity markets remained a major source of volatility and concern into 2016. Oil prices fell below USD 30/barrel – the lowest level since 2003. Base metals also suffered from continued weakness in emerging market growth. Gold benefitted somewhat from the worsening in risk sentiment, and we expect the gold price to stabilize around current levels. Contrary to commodities, hedge funds, as well as private market investments, offer attractive sources of alternative risk and return drivers, and should be considered by any investor who can tolerate limited liquidity.

Cross-asset preferences

	Most preferred	Least preferred
Equities	<ul style="list-style-type: none"> • Eurozone • US share buybacks and dividends • Eurozone "value" stocks • Water-linked investments 	<ul style="list-style-type: none"> • UK (↗) • Emerging markets
Bonds	<ul style="list-style-type: none"> • Global investment grade • Euro high yield • Corporate hybrids • Rising stars • European leveraged loans 	<ul style="list-style-type: none"> • Developed market high grade bonds
Foreign exchange	<ul style="list-style-type: none"> • NOK • USD (↗) 	<ul style="list-style-type: none"> • EUR • JPY (↘)
Hedge Funds & Private Markets	<ul style="list-style-type: none"> • Hedge funds: Favoring equity hedge 	
Precious Metals & Commodities		

Global model portfolio (EUR)



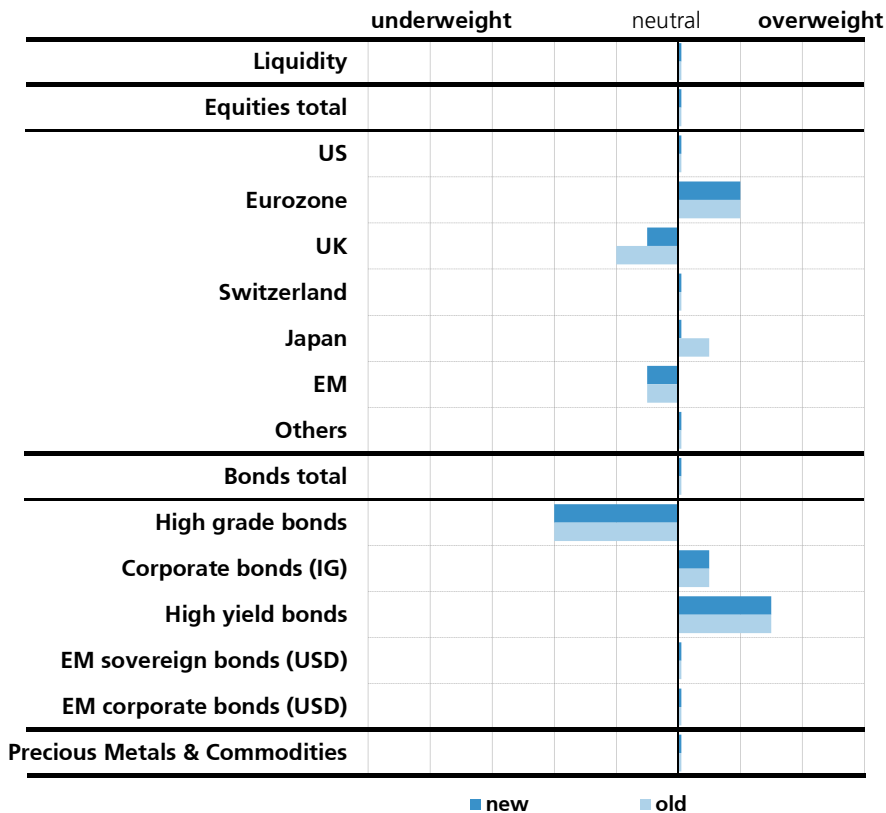
As of 21 January 2016

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 4.3% p.a. and volatility of 7.9% p.a. over the next five years.

↗ Recent Upgrade ↘ Recent Downgrade

Global tactical asset allocation

Tactical asset allocation deviations from benchmark*

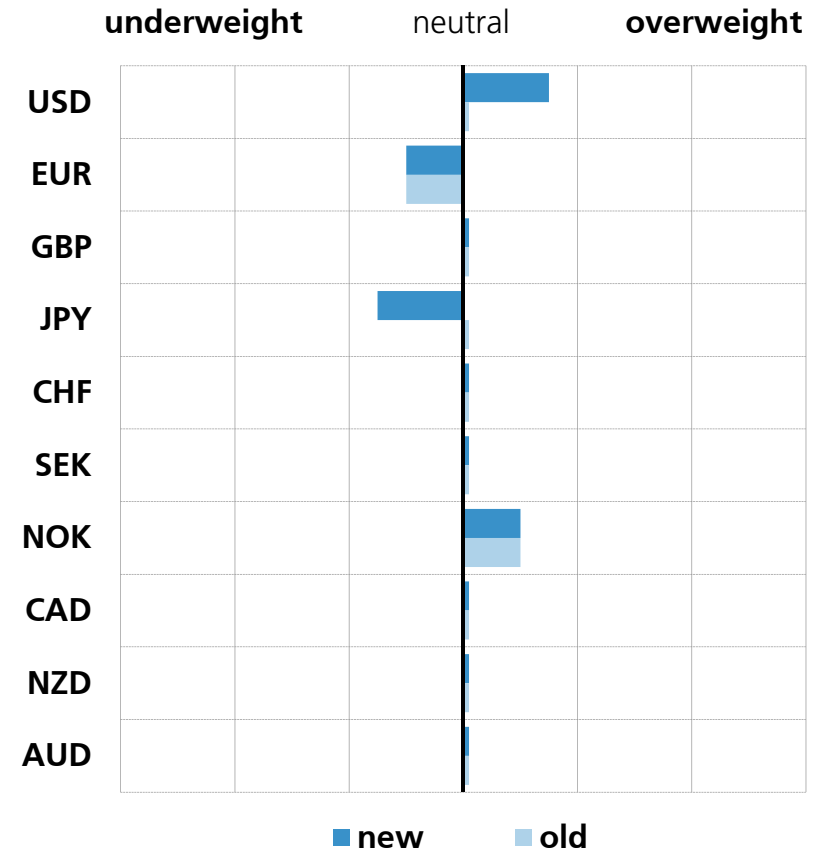


Source: UBS, as of 21 January 2016

*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

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

- **Eurozone value: Investing in style**

History shows that "value" tends to outperform at this stage of the business cycle. Before the onset of the financial crisis in 2007, European value outperformed in six out of the seven US economic expansion phases in the past 45 years. There is a strong, positive correlation between the relative performance of Eurozone value and US and German bond yields. Both should be supported by the prospect of accelerating growth and rising inflation in Europe and the US in 2016.

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 individual 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 BBB rating categories. In the absence of an upgrade, we still expect them to outperform investment grade corporates due to higher carry and potential further spread compression.

- **Opportunities in European leveraged loans**

European leveraged loans currently offer an average yield of 5.5%. We think that is an attractive level given the persistent global low-yield environment, particularly as we expect default rates to remain low. Our six-month total return expectation is 3%, and we see the asset class as an attractive opportunity for qualified investors. Loans benefit from having senior secured status, higher recovery rates than HY bonds, a floating-rate structure, low volatility and a favorable risk-return profile, in our view. There is an established trading market for loans, though liquidity is generally lower than for HY bonds. We regard loans as longer-term investments.

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

Euro high yield offers an attractive yield pick-up relative to higher-rated bonds, particularly considering our expectations for defaults to rise only moderately towards 2% in the next 12 months. Corporate fundamentals are solid, the ongoing Eurozone economic recovery is supportive of earnings and the accommodative stance of the ECB is a continued tailwind as it encourages investors to reach for yield. Our six-month total return expectations are 5-6%. Given the attractive risk-return profile of Euro high yield, 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

- **Favoring equity hedge strategies**

A gradual increase in US interest rates and a normalization of market volatility are likely to increase dispersion and stock mispricing. These dynamics should create a fertile environment for bottom-up stock-pickers to generate excess returns on long and short positions as company-specific fundamentals, rather than market movements, should fuel stock performance. We prefer managers running lower gross and net exposures with a strong focus on alpha generation (i.e. low beta long/short and market neutral managers).

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 show strong divergence between countries, while emerging markets remain the weakest link.
- We see the policies of major central banks diverging. The Federal Reserve hiked in December and is expected to gradually raise rates in 2016, while the ECB is under increasing pressure to do more.
- We believe inflation will remain subdued, even if divergences among countries are set to increase.

CIO view (Probability: 60%*)

World growth to improve moderately

- We expect global economic growth to improve moderately in 2016, but its composition will likely diverge. While we expect developed economies to advance, emerging economies should remain weak relative to historical levels given the limited room for stimulus measures, capital outflows and subdued export growth. High levels of private-sector debt also give reason for concern amid less favorable global liquidity conditions.
- We expect the US economy to be robust. In Europe, latest economic data suggest resilience against the backdrop of worldwide weak industrial production. Leading indicators also suggest some improvement. Within emerging markets, Asia is still the strongest region despite slowing growth, while EMEA and Latin America are lagging due to the weakness in large economies like Russia and Brazil.
- The recent fall in oil prices has delayed the recovery in inflation to the second half of 2016. However, subdued growth in emerging markets likely means that inflation-rate increases will mostly be visible in the developed world starting in the summer.
- The Fed hiked in December and is expected to gradually raise rates in 2016. The Bank of Japan (BoJ) should continue with its expansive monetary policy. The ECB is in wait-and-see mode now, but the recent oil price fall means that the probability of further monetary easing in 2016 has increased substantially.

↗ Positive scenario (Probability: 15%*)

Return to above-trend growth

- The US economy grows above 3%, with greater consumption and investment in equipment. Risks in the Eurozone, especially from the political side, peter out. Growth and inflation exceed forecasts, especially in 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: 25%*)

Global growth disappointments

- The Eurozone crisis deepens again. Worsening deflationary pressures, coupled with economic disappointments, push the ECB to ease monetary policy even further in a major way.
- The Chinese economy weakens abruptly due to a sharper downturn in property investment, 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, the Middle East) deepen, affect global risk sentiment, and potentially push oil prices higher again.

*Scenario probabilities are based on qualitative assessment.

Key dates

Jan 27	US FOMC meeting
Jan 29	Eurozone HICP inflation (January estimates)
Jan 29	Bank of Japan monetary policy statement
Feb 1	China manufacturing PMI (January)

Global growth likely to improve slightly in 2016

		Real GDP growth in %			Inflation in %		
		2015	2016F	2017F	2015	2016F	2017F
Americas	US	2.5	2.8	2.5	0.1	1.5	2.7
	Canada	1.1	2.2	2.5	1.5	1.9	2.0
	Brazil	-3.6	-2.8	0.7	10.6	6.4	1.2
Asia/Pacific	Japan	0.6	1.3	0.7	0.9	1.0	1.8
	Australia	2.2	2.6	2.7	1.5	2.2	1.5
	China	6.9	6.2	5.8	1.5	1.5	1.7
	India	7.1	7.6	7.8	5.0	4.6	1.9
Europe	Eurozone	1.5	1.8	1.8	0.0	0.7	1.6
	Germany	1.5	1.9	1.6	0.1	0.5	2.0
	France	1.1	1.5	1.7	0.1	0.8	0.3
	Italy	0.8	1.5	1.6	0.1	0.7	1.8
	Spain	3.2	2.7	2.3	-0.6	0.3	2.4
	UK	2.4	2.4	2.3	0.1	1.1	2.0
	Switzerland	1.0	1.4	1.8	-1.1	-0.4	1.6
World		3.1	3.3	3.4	3.5	3.8	1.5

Source: UBS, as of 18 January 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 likely to remain well above 50

Global purchasing managers' indices (PMIs)



Source: Haver Analytics, UBS, as of December 2015

Key financial market driver 1 - *Robust growth in the US*

Key points

- We expect robust growth in the US over the next 12 months.
- Core inflation should remain subdued but gradually trend higher as the recovery continues.
- The Fed hiked in December and is expected to gradually raise rates in 2016.

CIO view (Probability: 70%*)

- We expect robust US real GDP growth over the next 12 months. Improved US household and business fundamentals should support private domestic demand growth, though with a moderate drag due to a strong USD. Against a backdrop of falling unemployment and faster wage growth, the Fed started to raise rates in December. We expect the pace of rate hikes to be much more gradual than in previous tightening cycles.
- Housing starts should continue to increase and prices should remain on a modest upward trend.
- The negative impact of lower oil prices on energy sector fixed investment has been a significant drag on growth, particularly in the manufacturing sector, which remains stagnant.
- Fiscal policy should turn slightly positive for growth in FY2016. Major reforms are unlikely until after the presidential election.
- Core personal consumption expenditures (PCE) price inflation is being held in check by the strong USD, low energy prices and smaller-than-usual increases in healthcare costs. We expect these factors to fade, but inflation is likely to remain well below the Fed's 2% target over the next 12 months.
- An inventory correction cycle hurts growth in the second half of 2015 but should end soon.

Robust expansion

➤ Positive scenario (Probability: 15%*)

- US real GDP growth rises significantly above 3%, propelled by an expansive monetary policy, improved business and consumer confidence, strong housing investment, and subsiding risks overseas. The Fed raises policy rates significantly more than markets anticipate.

Strong expansion

⚠ Negative scenario (Probability: 15%*)

- 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.

Growth recession

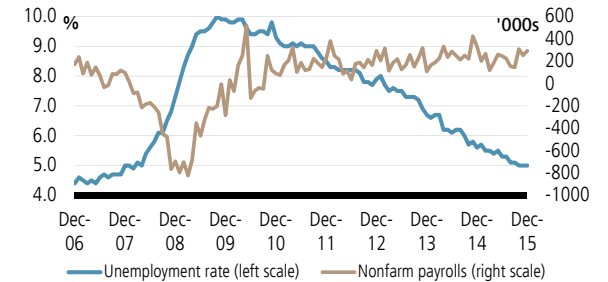
*Scenario probabilities are based on qualitative assessment.

Key dates

Jan 27	FOMC rate decision
Jan 28	Durable goods orders for December
Jan 29	4Q 2015 GDP
Jan 29	4Q Employment Cost Index
Feb 1	Personal income and spending for December

Improving labor market supports consumption

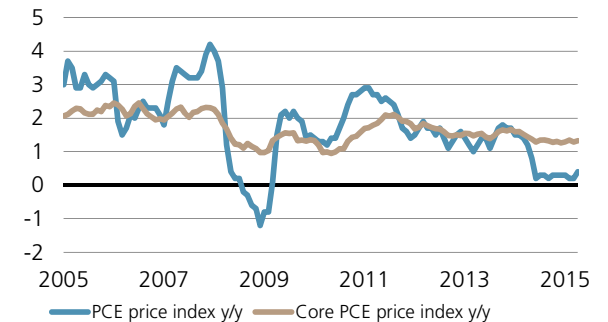
Unemployment rate in % and nonfarm payrolls in '000s



Source: Bloomberg, UBS, as of 12 January 2016

Low energy prices are curtailing inflation

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



Source: Bloomberg, UBS, as of 12 January 2016

Note: PCE = personal consumption expenditures

Key financial market driver 2 - *Improving Eurozone growth*

Key points

- Economic growth is set to improve in the coming quarters on the back of a very strong monetary impulse.
- The renewed sharp fall in oil prices suggests large downside risks to inflation forecasts.
- The probability for further ECB easing has increased substantially given the renewed fall in oil prices.

CIO view (Probability: 70%*)

Improving growth

- The Eurozone economy is likely to improve further in the coming quarters as the monetary impulse reaches its peak, with easy financing conditions supporting a capital expenditure boost. The renewed fall in oil prices means downside risks to inflation, in particular further weakness in the first half of 2016. The probability of further ECB easing around the second quarter has increased substantially, despite an accelerating Eurozone economy and the expected rate hikes in the US.
- In Germany, fundamentals, such as consumer confidence and the propensity for capital expenditures, remain robust. In addition, the immigration situation is leading to greater-than-expected government spending, helping the economy to continue growing solidly.
- French growth is set to hold up despite the tragic Paris attacks, supported by stabilizing construction in 2016. Strong QE-related wealth effects support consumption, and companies are expected to increase investment spending.
- In the periphery, Italy should consolidate its return to growth, supported by strong QE-related wealth effects, signs of life in its housing sector, and a fast pace of reforms. Spain, in turn, is posting strong growth rates. However, growth is set to moderate given the uncertainty surrounding the political situation.

➤ Positive scenario (Probability: 20%*)

Better-than-expected growth

- Oil prices and the euro decline more than expected, with loan demand and the economy recovering faster than envisaged. France follows a credible reform path and speeds up fiscal consolidation. Political risks fade further.

⚠ Negative scenario (Probability: 10%*)

Deflation spiral

- The Eurozone slips into a deflation 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

Jan 22	Eurozone PMIs (January estimates)
Jan 29	HICP inflation (January estimate)
Feb 12	Industrial production (December)
Feb 12	Eurozone GDP (4Q estimate)
Feb 19	Consumer Confidence (February estimate)

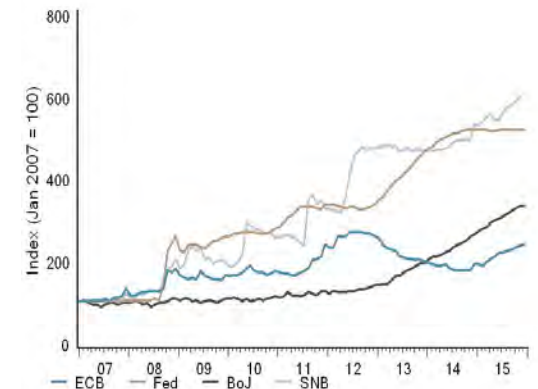
Eurozone composite PMI expected to improve further



Source: Haver Analytics, UBS, as of December 2015
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 December 2015

Key financial market driver 3 - *Resolving overcapacity*

Key points

- Resolving overcapacity will be a key priority this year. Economic growth will therefore likely continue to decelerate, accompanied by higher bankruptcy and jobless numbers.
- However, we do not expect a hard landing as policy will be accommodative to guide and facilitate transformation.
- Deep adjustments in old manufacturing and rising new manufacturing and service sectors will decide China's success in transforming.

CIO view (Probability: 80%*)

- We forecast China's GDP to grow by 6.2% in 2016. As China transforms, the manufacturing PMI is likely to remain in contraction territory, while the services PMI is expected to stay above 50.
- Investment will continue to decelerate, dragged down by traditional manufacturing and real estate; consumption is expected to grow mildly, contributing 56% to GDP growth in 2016 from 54% in 2015.
- CPI inflation will rise mildly to 2% in 2016, mainly due to rising pork prices and a low base for comparison. PPI inflation will rebound slightly but remain negative.
- Fiscal policy is the key to economic stability and structural reforms. The fiscal deficit is likely to rise to 2.8%-3% of GDP in 2016 to prevent a potential slump. Fiscal spending will focus on three major fields: 1) facilitating re-employment and training for those made redundant in sectors with overcapacity; 2) supporting small and medium-sized firms via cost-saving policies; and 3) promoting new manufacturing sectors via government-involved PE funds and fiscal credits.
- Monetary policy will stay accommodative. In 2016, we expect 1-2 cuts in benchmark interest rates, 300-500 basis points cuts in the reserve requirement ratio and 50-100 basis points cuts in the SLF (Standing Lending Facility).
- Destocking in the real estate sector will continue to put downward pressure on both prices and sales. Inventory in tier-3 or tier-4 cities is estimated to be around 25-30 months implying 2-3 years' adjustment in the sector. Fiscal policy will assist migrant workers in purchasing housing to reduce housing inventories via fiscal subsidies and reforms in land and hukou systems.

↗ Positive scenario (Probability: 10%*)

- Annual growth is 6.8% year-on-year as a result of more substantial policy stimulus measures from the government or a strong pick-up 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.

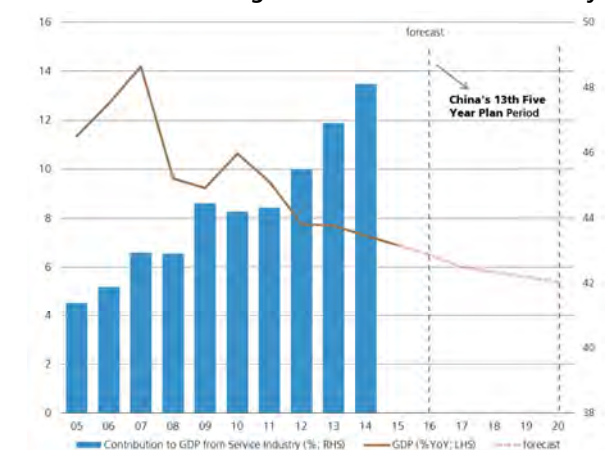
* Scenario probabilities are based on qualitative assessment.

Key dates

Feb 15	Trade data for January
Feb 10-15	Monetary and credit data for January
Feb 18	CPI, PPI for January

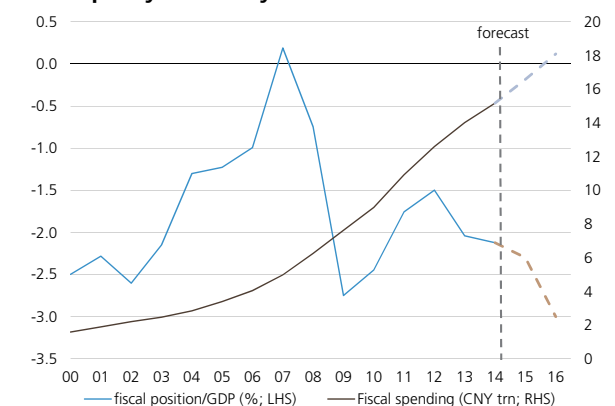
Policy support to moderate slowdown

China is transitioning to a services-driven economy



Source: CEIC, UBS, as of 11 January 2016

Fiscal policy is the key in 2016



Source: CEIC, UBS, as of 11 January 2016

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Version 01/2016.

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