UBS

UBS House View

Monthly Base June 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

"Solid US macro data and a stabilization in China support our moderate risk-on stance, expressed in overweight positions in US equities and euro high yield bonds"

- **Asset allocation**
  Following the strong recovery since mid-February, global equity prices have given back a little over the past month. Still, our outlook for risk assets remains constructive. Global growth is holding up at a moderate level and central banks remain very accommodative. The recent re-pricing of future US rate hikes has not caused a significant market draw-down, as it is accompanied by solid US macro data. The growth/inflation mix remains positive – a fact that's also supported by our models. We expect the Fed to tread cautiously and tighten policy only gradually. The drag on global growth, stemming from investment cuts in commodity and manufacturing sectors, is abating. China, while still vulnerable to setbacks, has stabilized its economy and currency outflows have slowed. Policymakers' willingness to prevent a significant economic cooling added to our confidence in maintaining a moderate risk-on stance, expressed in tactical overweight positions in US equities and euro high yield bonds.

- **Equities**
  US and some emerging market equity indices have achieved positive total returns year-to-date, while European stocks are lagging. We are holding a tactical overweight in US equities against high grade bonds. Corporate earnings, both in the US and in Europe, have been undeniably weak in the first quarter, but there are signs of improvement for the rest of the year. Several headwinds for US earnings in recent quarters - such as the strong US dollar, extremely low oil prices and elevated corporate bond spreads – are past their peak negative impact. US earnings margins have already corrected downwards. Unless there's a US recession, which we find unlikely, margins are unlikely to decline further.

- **Bonds**
  Corporate bonds have staged an impressive rally from the lows in February. A well-diversified portfolio of credit assets (incl. less liquid ones like senior loans) has performed very well since the beginning of the year. We are maintaining a tactical overweight in euro high yield bonds, supported by a persistently low default rate of just 0.6% over the past 12 months, a decent yield pickup of 4.7% over government bonds and the support measures of the ECB. We furthermore prefer US investment grade bonds with medium maturities (1-10 years) over higher rated bonds for their attractive extra yield and manageable credit risks. Investors, who are able to tolerate a higher degree of illiquidity, will also find good value in senior loans, offering a yield of 6.5% in the US and 5.2% in Europe.

- **Foreign exchange**
  We are closing our overweight position in the Canadian over the Australian dollar, taking profits. While we still expect the Australian dollar to weaken - as expressed in our maintained underweight versus the US dollar - we acknowledge that part of our investment case has played out. Interest rate expectations have adjusted downwards as the Australian central bank cut the policy rate to a new all-time low. At the same time the wildfires in Canada could introduce some volatility into economic data in the months to come. Besides our USDAUD position, we maintain an overweight in the Norwegian krone against the Euro. Positive economic momentum in Norway and an inflation gap of 3.5 percentage points towards the Eurozone support further appreciation of the NOK.

- **Alternative investments and precious metals & 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. We continuously advise against direct commodity exposure within well-diversified portfolios, based on an unattractive risk-return outlook. Within commodities, we foresee further volatility ahead for the oil price. Gold has recently suffered from expectations of rising US interest rates. CIO forecasts a gold price of 1'200 USD in 6 months.

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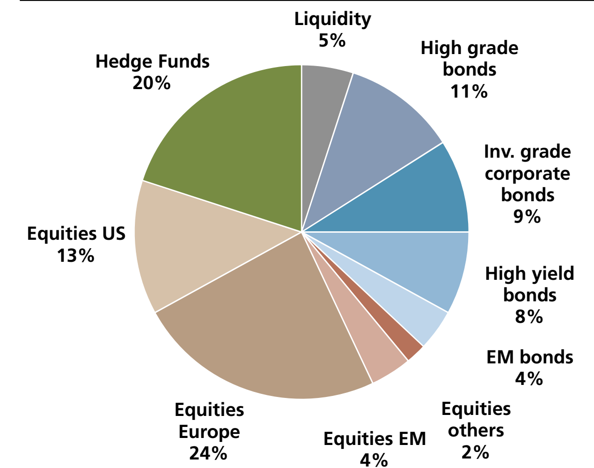
Cross-asset preferences

	Most preferred	Least preferred
Equities	• US equities • US share buybacks and dividends • US technology • Water-linked investments	
Bonds	• US investment grade • Euro high yield • Corporate hybrids • Rising stars • US leveraged loans	• Developed market high grade bonds
Foreign exchange	• NOK • USD	• EUR • AUD (↗)
Hedge Funds & Private Markets	• Hedge funds: Event-driven strategies	
Precious Metals & Commodities		

Global model portfolio (EUR)



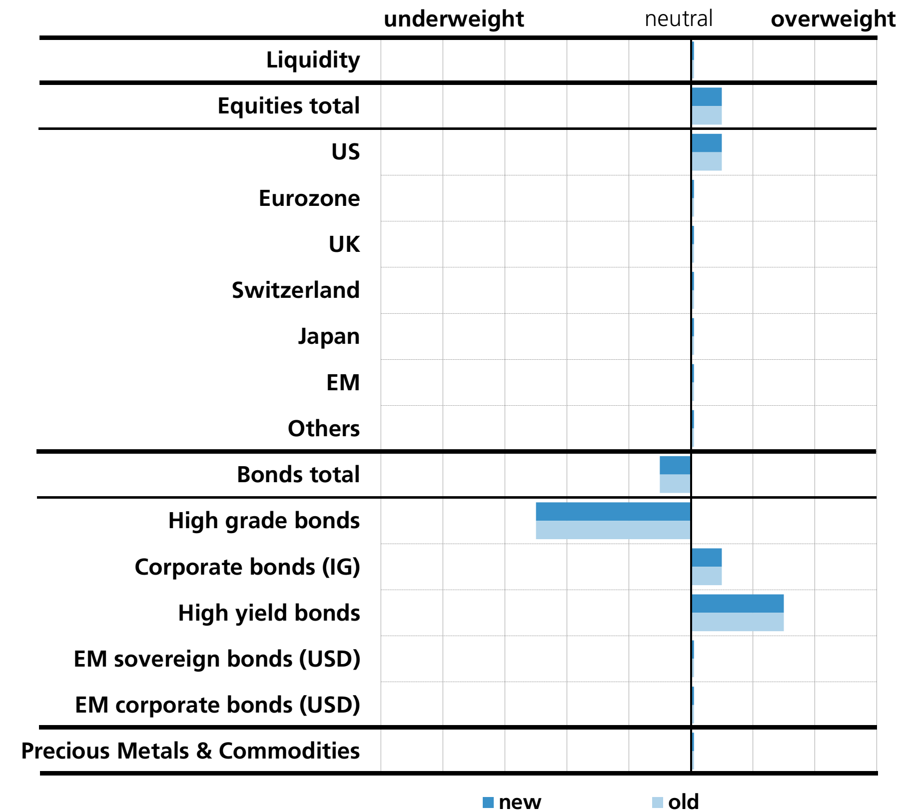
As of 26 May 2016

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.

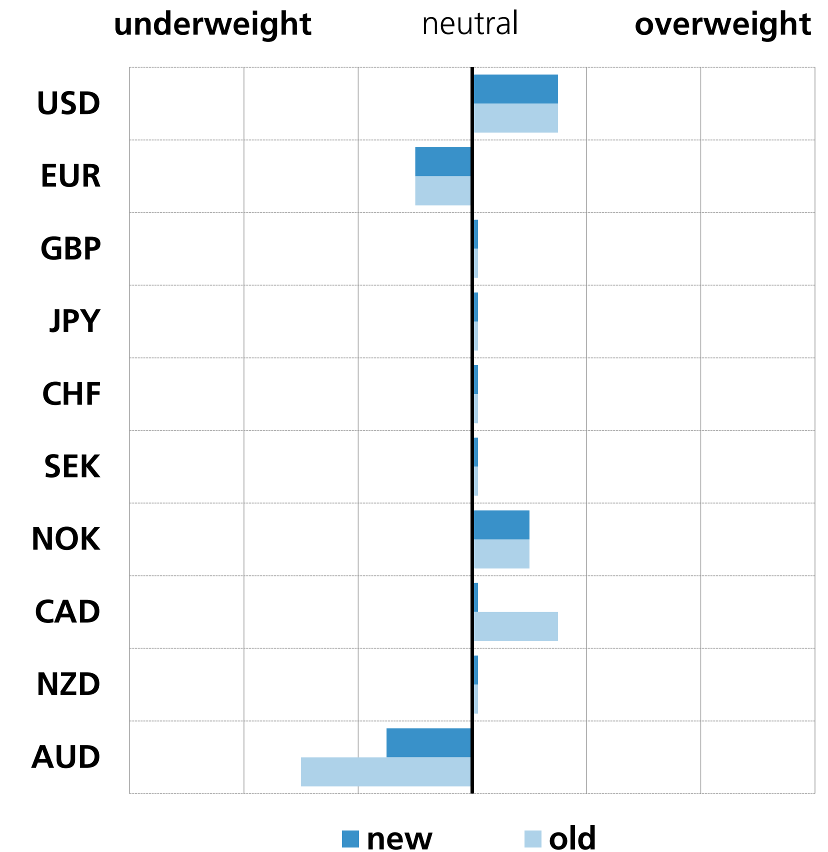
↗ Recent Upgrade ↘ Recent Downgrade

Global tactical asset allocation

Tactical asset allocation deviations from benchmark*



Currency allocation



Source: UBS, as of 26 May 2016

*Please note that the bar charts show total portfolio preferences. Thus, it can be interpreted as the recommended deviation from the relevant portfolio benchmark for any given asset class and sub-asset class.

The UBS Investment House View is reflected in the majority of UBS Discretionary Mandates and forms the basis of UBS Advisory Mandates. Note that the implementation in Discretionary or Advisory Mandates might deviate slightly from the "unconstrained" asset allocation shown above, depending on benchmarks, currency positions, and other implementation considerations.

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 6.5% is attractive, while we think prices should continue to moderately 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% 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 toward 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. Emerging markets should stabilize at weak levels.
- We believe inflation will remain subdued globally, even if divergences among countries increase.
- The policies of major central banks are expected to diverge. The US Federal Reserve hiked rates in December 2015 and is likely 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 nations faring well and emerging markets (EM) stabilizing at weak levels relative to historical growth rates.
- We expect moderate US economic growth. In Europe, sound domestic fundamentals should limit negative spillovers from external shocks. Within EM, Asia is still the strongest region despite slowing growth, while EMEA and Latin America are lagging due to weakness in Russia and Brazil.
- 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 should 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, 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

June 2	Eurozone: Monetary policy meeting
June 3	China: Caixin Manufacturing PMI (May)
June 15	US: FOMC rate decision
June 16	Japan: BoJ monetary policy meeting

Global growth broadly stable in 2016

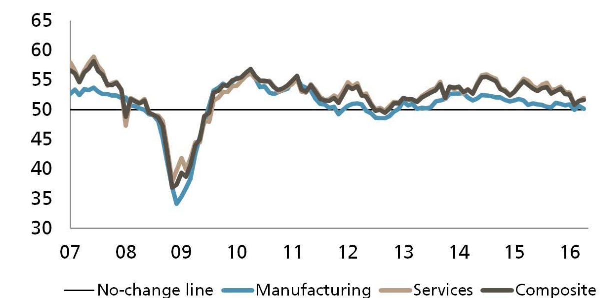
		Real GDP growth in %			Inflation in %		
		2015	2016F	2017F	2015	2016F	2017F
Americas	US	2.4	1.5	2.5	0.1	1.6	2.5
	Canada	1.2	1.9	2.5	1.1	1.7	1.9
	Brazil	-3.8	-3.5	0.8	10.7	6.4	4.7
Asia/Pacific	Japan	0.6	0.8	0.4	0.8	0.1	1.5
	Australia	2.5	2.5	2.7	1.5	1.3	2.0
	China	6.9	6.6	6.3	1.4	1.9	2.0
	India	7.6	7.4	7.6	4.9	4.6	4.2
Europe	Eurozone	1.6	1.6	1.7	0.0	0.2	1.5
	Germany	1.5	1.6	1.5	0.1	0.3	1.6
	France	1.2	1.5	1.7	0.4	0.1	1.5
	Italy	0.6	1.1	1.2	0.1	0.0	1.6
	Spain	3.2	2.9	2.2	-0.6	-0.5	1.7
	UK	2.3	2.0	2.3	0.0	0.6	1.5
	Switzerland	0.9	1.0	1.5	-1.1	-0.3	0.4
	Russia	-3.7	-0.6	1.5	15.5	7.2	5.4
World		3.2	2.9	3.4	3.5	3.6	3.5

Source: UBS, as of 23 May 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 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 remaining above 50 in April.
- An inventory correction cycle has been a drag on growth since the second half of 2015, 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 inflation is likely to reach the Federal Reserve's 2% target within the next 12 months.
- Fiscal policy will be slightly positive for growth in 2016, as politicians agreed to spending increases and tax cuts ahead of the presidential election. Major policy reforms are unlikely until after the new president takes office in January 2017. Political uncertainty is a potential downside risk for growth.
- The Fed hiked rates by 25 basis points in December 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.

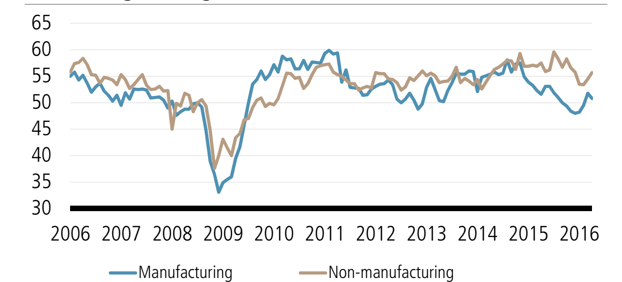
*Scenario probabilities are based on qualitative assessment.

Key dates

May 31	Personal income and spending for April
Jun 1	ISM manufacturing for May
Jun 3	ISM non-manufacturing for May
Jun 3	Labor report for May

PMIs consistent with moderate growth

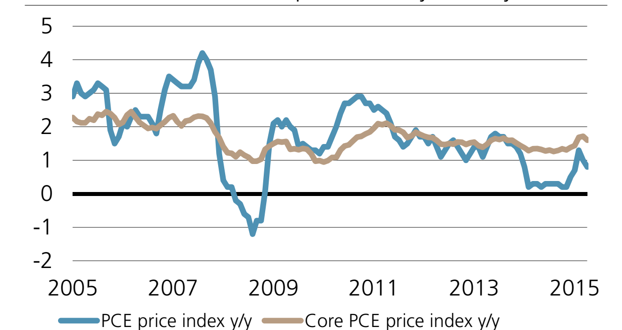
Purchasing Managers' Indices



Source: Bloomberg, UBS, as of 18 May 2016

Inflation will gradually move toward the Fed's 2% target

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



Source: Bloomberg, UBS, as of 18 May 2016

Note: PCE = personal consumption expenditures

Key financial market driver 2 - *Steady Eurozone growth*

Key points

- We expect economic growth to remain solid despite global hindrances.
- Inflation should remain weak in the spring before starting to rebound in the summer.
- Following the recent comprehensive easing measures, the ECB is likely to remain on hold and is now in a wait-and-see mode.

CIO view (Probability: 60%*) **Steady growth**

- We expect the Eurozone economy to weather global growth concerns, supported by more fiscal spending on refugees and strong monetary impulse. Inflation is set to remain weak during the spring and start rising in the summer. In anticipation of such a rebound, the ECB is likely 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 through greater-than-expected government spending.
- In France, better dynamics in construction are helping solidify growth. Consumption is set to improve, and companies are set to increase investment spending.
- In the periphery, Italian growth should consolidate, supported by its construction sector and by greater regulatory visibility in its banking sector. Spain, in turn, is still 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**

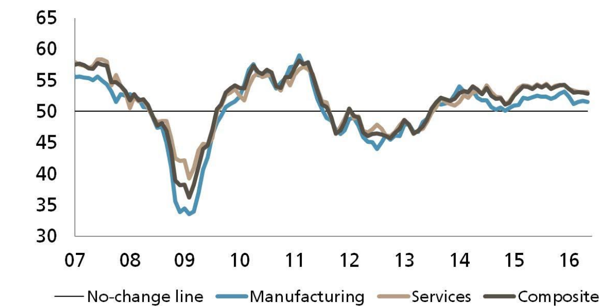
- The Eurozone slips into a deflationary spiral due to a shock, such as Greece leaving the Eurozone, a sharp escalation in the Ukraine conflict, or China suffering a severe economic downturn.

*Scenario probabilities are based on qualitative assessment.

Key dates

May 31	HICP inflation (May estimate)
June 2	ECB monetary policy meeting
June 3	Retail sales (April)
June 14	Industrial production (April)
June 22	Consumer confidence (June)

Eurozone composite PMI expected to remain solid

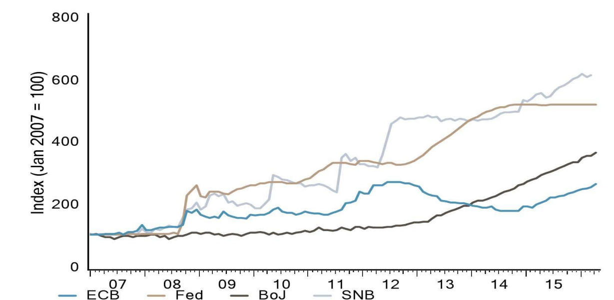


Source: Haver Analytics, UBS, as of May 2016

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 April 2016

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

Key points

- China's economic policy tone appears to have shifted, with supply-side reforms being the current focus.
- Fiscal policy in 2016 will be critical in supporting small and medium-sized enterprises and new manufacturing sectors.
- We expect accommodative policy to guide and facilitate China's economic transformation, thereby averting a hard landing.

CIO view (Probability: 80%*) **Policy support to moderate slowdown**

- Chinese economic activity slowed again in April after surging in March, in line with our view that the country's debt-fueled growth is unsustainable. Industrial production growth fell to 6% due to deep adjustments in traditional manufacturing. Fixed asset investment growth from January to April decelerated to 10.5% on lower manufacturing and infrastructure spending. Private investment growth plunged to 5.2%, while retail sales growth declined to 10.1%, dragged by auto sales. A recent state newspaper's interview with "a person with authority," believed to be President Xi Jinping, cited private investment as China's biggest economic risk. We still expect a prolonged L-shaped slowdown in the economy, but in an orderly manner supported by accommodative policy.
- Fiscal policy in 2016 will be critical in supporting small and medium-sized enterprises through cost-saving measures and tax reforms, and in promoting new manufacturing sectors through government-related private equity funds and fiscal credits. This year's fiscal deficit is expected to reach 4% of GDP, or about CNY 20trn in spending.
- Monetary policy will likely remain accommodative. We see potential cuts in interest rates and banks' reserve requirement ratio, as well as aggressive liquidity injections. Policymakers are trying to avoid systemic financial risks amid worsening credit conditions in a slowing economy. A CNY 1trn debt-for-equity swap program may be launched in the next three years.
- Consumer price inflation, which came in at 2.1% in 1Q16, should rise mildly during the year mainly due to rising pork prices and a low base of comparison. Producer prices should rebound slightly but remain in deflation.
- The housing market continues to face downward pressure from the inventory overhang in low-tier cities. The recent buying fever in top-tier cities has helped little in resolving serious inventory issues as a whole. We foresee housing policy constraints in the latter city category and supportive measures in the former.

Positive scenario (Probability: 10%*) **Growth acceleration**

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

Negative scenario (Probability: 10%*) **Sharp economic downturn**

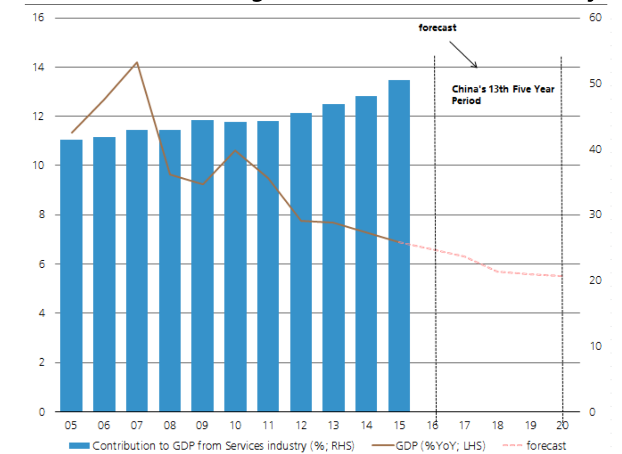
- A hard landing materializes, which we define as sub-5% real GDP growth for more than two quarters. The economy weakens abruptly due to a sharper downturn in property investment and widespread credit events.

* Scenario probabilities are based on qualitative assessment.

Key dates

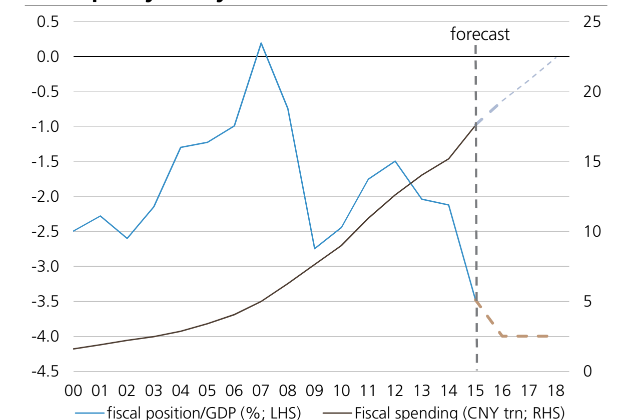
Jun 8	Trade data for May
Jun 9	CPI, PPI for May
Jun 10-15	Monetary and credit data for May
Jun 12	Industrial production, fixed asset investment, retail sales for May

China is transitioning to a services-driven economy



Source: CEIC, UBS, as of 17 May 2016

Fiscal policy is key in 2016



Source: CEIC, UBS, as of 17 May 2016

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