

# UBS House View

Monthly Base **November 2016**

**Chief Investment Office WM**

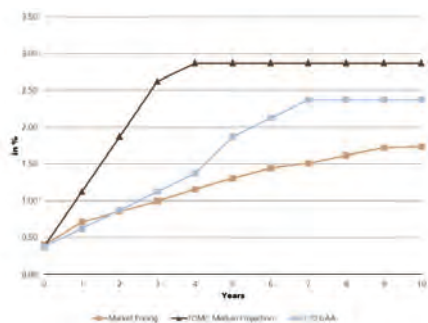
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Published  
Oct 20 2016



# Financial Market Outlook – short-term (6 months)

## Expectation for Federal Funds Rate Path



Source: UBS CIO, as of end September 2016

## Tightening of Corporate Investment Grade Spreads



Source: UBS CIO, as of September 2016

## Global Tactical Asset Allocation (TAA)

### • Asset allocation

We expect the global economic recovery to continue at a gradual but relatively solid pace. With the US labor market continuing to tighten, credit spreads significantly lower than a year ago and financial markets relatively stable, we expect the Fed to continue its gradual tightening before year end. This is in our view appropriately priced in financial markets. Additionally US earnings are expected to start growing soon, and we maintain tactical overweight positions in US equities and US investment grade bonds against high grade bonds. We furthermore prefer emerging market (EM) equities over Swiss stocks and a basket of EM currencies over DM currencies. We are opening an overweight in US inflation-protected securities (TIPS) against high grade bonds.

### • Equities

Our overweight in US equities remains supported by solid US data. In particular US private consumption is holding up well, while leading business indicators recovered significantly over the past month. Besides our overweight in US equities we hold an overweight in EM against Swiss stocks. Earnings of EM companies have turned positive over the past 6 months, while economic data in the region has stabilized. Meanwhile Swiss equities are likely to underperform due to their defensive sector mix and the ongoing drag of negative interest rates on financials' earnings.

### • Bonds

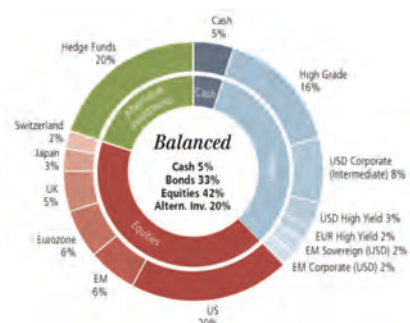
High grade bonds remain a key diversifier of our global portfolios, but tactically we find better opportunities in US investment grade bonds, providing a yield of 2.4%. We furthermore recommend shifting some HG exposure into US inflation-protected securities (TIPS) as we think inflation is underpriced. Qualified investors, who can tolerate somewhat lower liquidity, should overweight US senior loans, offering an average yield of 6% and floating interest rates.

### • Foreign exchange

We are holding an overweight in a basket of EM currencies (BRL, INR, RUB, ZAR) against an underweight in DM currencies (AUD, CAD, SEK) to harvest the attractive interest rate carry. The cyclical nature of our DM basket helps to reduce the risk of this position to some extent (e.g. compared to an USD underweight).

# Financial Market Outlook – long-term (5+ years)

## Balanced Strategic Asset Allocation (USD)



Source: UBS CIO, as of October 2016

## High Grade bond yields (in %) have declined significantly



Source: UBS CIO, as of October 2016

## Strategic Asset Allocation (SAA)

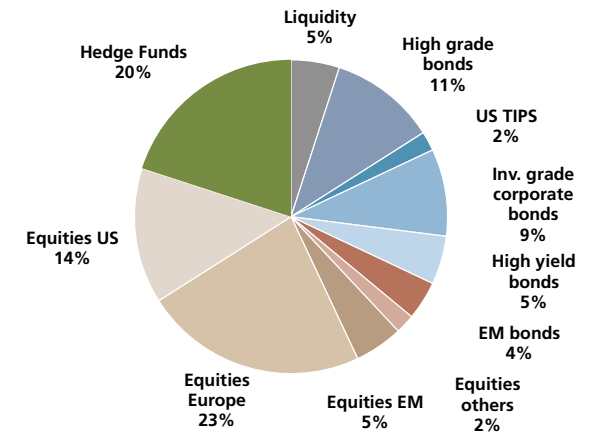
- Our SAAs offer investors the best risk / return trade-off consistent with a modern portfolio theory approach by investing in traditional, relatively liquid asset classes and making use of diversification to reduce risk. They are set up to withstand different types of market environments and are reviewed at least annually.
- Each asset class enters the portfolio based on our internally constructed Capital Markets Assumptions (CMAs), i.e. forward-looking risk and return expectations. These also form the basis of the optimal asset weightings in our innovative complementary long-term asset allocation strategies, UBS' new investment solutions.
- In recent years we have added high yield bonds, EM sovereign and corporate bonds and also reduced the cash allocation. We recommend global exposure to equities, a larger spectrum of bonds diversified across styles, quality, regions, central bank exposures and durations and exposure to multi-strategy alternative investments.
- We have been recommending to refrain from any direct commodity holdings, including precious metals, since the beginning of 2014 as we think the expected risk / return trade-off of the asset class is not attractive enough.
- We recommend to fully hedge foreign currency exposure (except for EM equities) in our SAAs. The volatility of the asset class together with the potential for structural shifts in FX regimes is not compensated for by the expected returns.
- Our SAAs have benefited, year to date, from the strong run in fixed income asset classes, both high grade and corporates, as well as equities. The recent market volatility in September across these asset classes has had a limited impact on our SAAs, and higher risk profile portfolios have been more affected than lower risk portfolios.

# 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 EMs</li> </ul>	<ul style="list-style-type: none"> <li>● Switzerland</li> </ul>
<b>Bonds</b>	<ul style="list-style-type: none"> <li>● US investment grade</li> <li>● Corporate hybrids</li> <li>● US leveraged loans</li> <li>● US TIPS ( ↗ )</li> </ul>	<ul style="list-style-type: none"> <li>● Developed market high grade bonds ( ↘ )</li> <li>● Replacing "well-worn" bonds ( ↘ )</li> </ul>
<b>Foreign exchange</b>	<ul style="list-style-type: none"> <li>● EM FX (BRL, INR, RUB, ZAR)</li> </ul>	<ul style="list-style-type: none"> <li>● DM FX (AUD, CAD, SEK)</li> </ul>
<b>Hedge Funds</b>	<ul style="list-style-type: none"> <li>● Event-driven strategies</li> </ul>	
<b>Precious Metals &amp; Commodities</b>		

↗ Recent Upgrade   ↘ Recent Downgrade

## Global model portfolio (EUR)

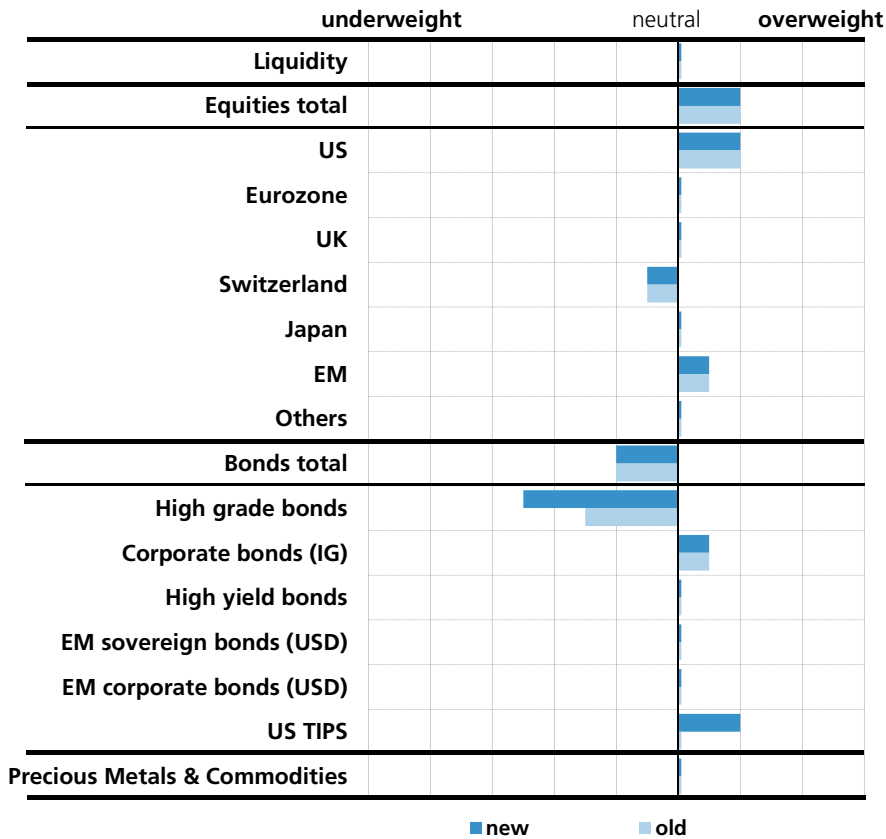


As of 20 October 2016

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.

# Global tactical asset allocation

## Tactical asset allocation deviations from benchmark\*

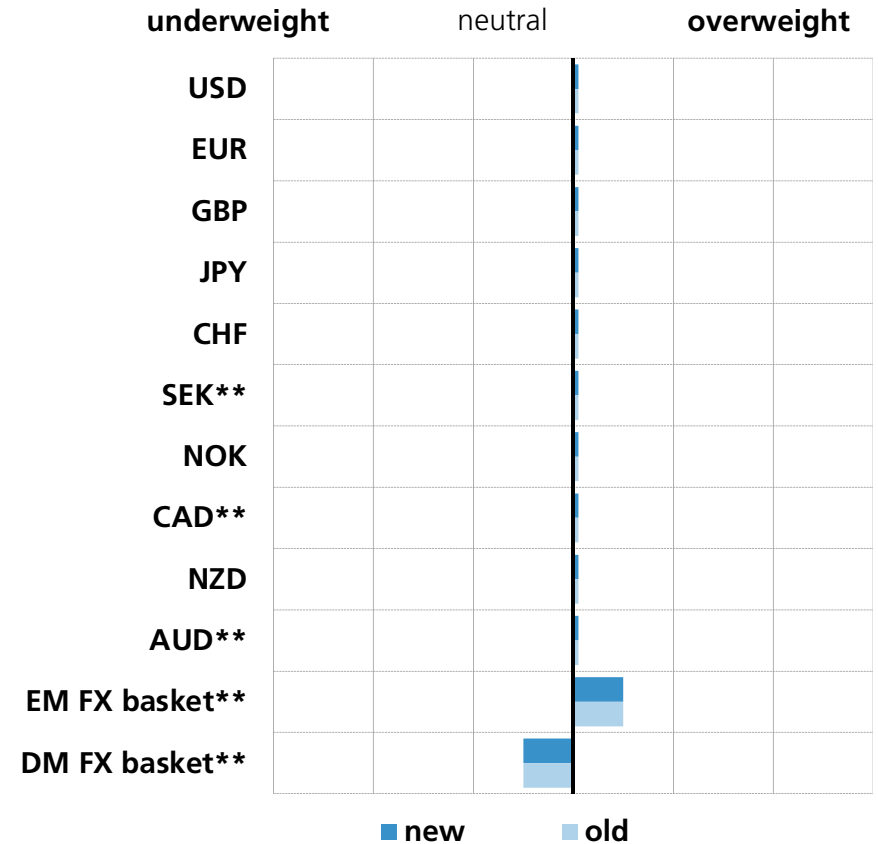


Source: UBS, as of 20 October 2016

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

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

## Currency allocation



\*\*The EM FX basket consists of the Brazilian real, the Indian rupee, the Russian ruble and the South African rand. The DM FX basket consists of the Australian dollar, the Canadian dollar and the Swedish krona (all with equal weights)

# 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-rate 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 comes from share buybacks. With borrowing costs low, companies have an incentive to return cash to shareholders, and good free cash flow generation is 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 a strong management to reduce tail-risk events such as severe environmental accidents or weak corporate governance (e.g. accounting/audit issues). As corporate emerging market 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.

## Bonds

- **A tip on TIPS: Benefiting from rising inflation**

We believe future consumer price inflation in the US is underestimated by current market pricing. Rising oil prices, a tighter labor market and the strong USD leveling off should provide support for headline inflation to move higher. We think this provides an opportunity for a long position in US Treasury Inflation Protected Securities (TIPS) funded by a short position in nominal US Treasuries. This so-called inflation breakeven trade offers excess return potential of 1-3% for investors with a minimum investment horizon of 12 months. The 3-7-year maturity spectrum of the curve is our best "tip". TIPS also add portfolio diversification and provide some hedge against a fall in the real value of accumulated capital should inflation climb further.

- **Replacing well-worn bonds**

Risk-free yields in most major developed markets are either below or close to zero. Even if rates were to remain unchanged, many shorter to medium-term bonds would deliver negative total returns. Investors who avoid negative yields and instead added longer-dated paper at a slightly positive yield often take an even greater risk. We do not intend to take a strong view on the highly uncertain path of inflation and yield curves, but we believe that investors can preserve wealth by taking profits on assets that will deliver negative total returns (exceeding costs of switching out) in most likely scenarios. More attractive alternatives can be found on CIO's bond recommendation lists.

- **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 benefits from a rise in short-term US interest rates. The recent rise in the USD LIBOR rate above 0.8% supports the investment case. The current yield (to 3-year takeout) at roughly 6.0% is attractive. We expect the default rate to moderately increase towards its long-term average of 3% in 12 months. 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 pick-up with corporate hybrids**

Corporate hybrid is a niche segment in the corporate bond market. At current spread levels, investors with a suitable risk tolerance are well compensated for assuming the risks associated with these bonds. We expect mid-single-digit percentage returns on selected instruments over 12 months.

# CIO themes in focus

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## *Alternative investments*

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

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

This selection of themes is a subset of a larger theme universe. The selection represents the highest conviction themes of the UBS Chief Investment Office WM, taking the current market environment and risk-return characteristics into account.

# CIO longer-term investment themes in focus

## Equities

- **Security and safety** 

Security and safety touch lives everywhere, from governments securing infrastructure to enterprises protecting data, and consumers trusting products as varied as baby food and fire alarms. Several long-term drivers support the theme: urbanization, tighter regulation and growing consumer awareness about product quality, data security, environmental protection and social responsibility, to name a few.

- **Automation and robotics** 

We believe smart automation is powering the ongoing industrial revolution, combining the innovation capabilities of industrial and IT processes to drive global manufacturing productivity gains. Rising wages and challenging demographic developments will pressure costs of manufacturing companies in emerging markets, driving automation investments. By powering machine intelligence, Artificial Intelligence (AI) should take automation to the next level.

- **Emerging market tourism**

Urbanization and income growth in emerging markets (EMs) are fueling a boom in global travel. Aviation services can be accessed in EMs' largest cities, which are expanding due to migration, and have the highest incomes. EM governments are supporting tourism as a strategy to diversify their economies. Policy support comes in the form of visa openness, public investment in aviation infrastructure and new air links.

- **Energy efficiency** 

Energy efficiency covers wide-ranging issues with numerous characteristics and starting points for promising investment opportunities. In general, energy efficiency as a field is gaining importance all over the world, and developments are driven more and more by governmental initiatives. Rising environmental pollution has led to an increased worldwide awareness.

- **Digital data**

Driven by strong urbanization, the global digital universe is expected to expand 50-fold between 2010 and 2020. From an investment perspective, digital data is a trend that offers solid long-term growth opportunities as significant investments are required to support the surge in data. Investors can participate by investing in either data enablers or data infrastructure companies.

The Longer-Term Investment (LTI) theme series focuses on inevitable global trends such as population growth, aging, and urbanization. These trends create a variety of opportunities, with certain companies and sub-sectors experiencing higher-than-GDP levels of revenue growth. We examine here a sub-set of a larger universe of longer-term investment themes that are expected to offer good entry points for theme-oriented investors over the coming months while highlighting our preference for a diversified approach to themes.



UBS Chief Investment Office WM considers the highlighted themes as fitting the sustainability framework



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

## Key points

- We expect the US Federal Reserve to raise rates by 25 basis points in December.
- The ECB is likely to extend its asset purchases beyond March, while tapering in 2017.
- Visibility on Bank of England policy is reduced by currency volatility.

## CIO view (Probability: 70%)

### Policy is diverging

- Ideological divisions within the US Federal Reserve have been evident in both public appearances by members of the FOMC and in the minutes of recent policy decisions. The market focus continues to emphasize the monetary policy pillar, and we believe a 25bps increase in the fed funds rate in December 2016 is warranted by higher inflation and the relatively tight labor market. The quantitative policy position (measured by the Fed's balance-sheet-to-GDP ratio) continues to moderately tighten. One possible political issue for 2017 is the risk of more aggressive regulation on the financial sector.
- The market has chosen to interpret some comments from ECB members as suggesting less enthusiasm for quantitative policy beyond the formal March 2017 deadline. We expect the ECB's quantitative policy program to be extended with EUR 80bn or less in monthly bond purchases beyond the current end date of March and to taper in 2017. The nature of the tapering has not, apparently, been formally discussed hitherto; speculation about the structure of any tapering is likely to concern markets around future ECB meetings.
- The Bank of England's policy stance may have to factor in the further decline in sterling in October, following politically-induced uncertainty about the economic outlook. The potential for higher import prices like food and fuel - disproportionately important in the minds of consumers - is increasing. At the same time, the economy does appear to have held up better than initially feared; this could induce a delay to any further easing measures. The Swiss National Bank has held its policy steady, and we believe it will continue with its current negative rate position for the next 12 months. The Bank of Japan has offered an additional policy initiative with a further target shift (now focusing on the longer end of the yield curve), but has also perhaps signaled a reluctance to engage in taking rates deeper into negative territory.

## ↗ Positive scenario (Probability: 15%)

### Worse macro backdrop

- The Fed is forced to stay on hold, but a rate cut remains unlikely. The ECB launches more policy easing than expected by the markets, with a focus on stabilizing or increasing bank credit growth. The Bank of Japan comes under pressure to engineer currency depreciation.

## ↘ Negative scenario (Probability: 15%)

### Macro risks fade

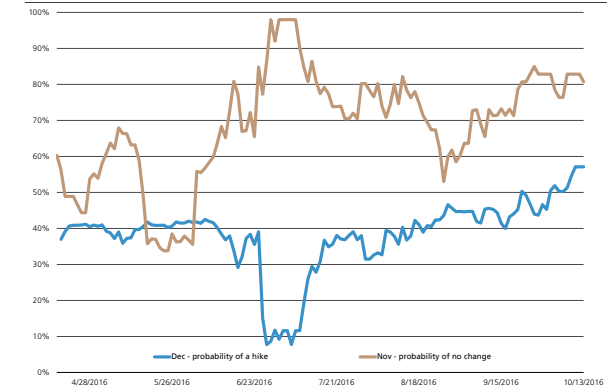
- Diminished risks allow the Fed to signal more aggressive policy tightening in 2017, with the debate between a faster pace of monetary tightening and a move towards a faster pace of quantitative tightening. The ECB reacts to the increase in inflation by giving stronger signals of a less accommodative mindset, raising questions about the future direction of quantitative policy. The Bank of England slows quantitative policy measures. Better growth prospects limit the impact of policy tightening on emerging markets.

## Key dates

<b>Nov 1</b>	Bank of Japan policy decision
<b>Nov 2</b>	US Federal Reserve policy decision
<b>Nov 3</b>	Bank of England policy decision and inflation report
<b>Nov 23</b>	Minutes of November US Federal Reserve meeting

## Markets expects no change in November, hike in December

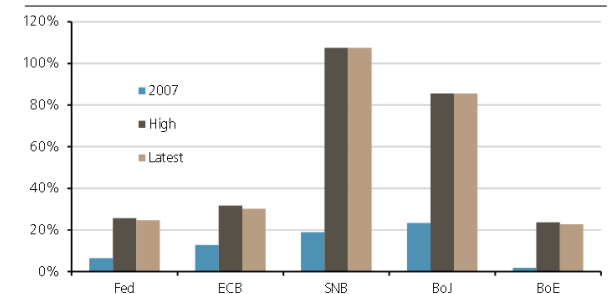
Fed fund futures probability of no change (Nov) and a hike (Dec) in %



Bloomberg, UBS, as of 13 October 2016

## Divergent quantitative policy

Central bank balance sheets as % GDP



Haver, UBS, as of 13 October 2016

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

## Key points

- We remain cautious on oil prices in the short term. OPEC's production cuts are, at this stage, all talk and no action. September crude output rose to a record 33.6mbpd and October production could approach 34mbpd.
- We remain confident that a combination of contracting non-OPEC supply and rising oil demand in emerging markets will result in a balanced oil market next year, which should lead Brent oil prices to USD 55/bbl or higher in 12 months.
- We therefore like to sell downside protection for a premium versus money market rates, with strikes close to USD 40/bbl.

## CIO view (Probability: 70%)

- OPEC surprised us and the market late September by departing from its volume-maximizing strategy in favor of actively managing supply. The deal faces many hurdles, some of which could be fatal, such as a lack of information on how a cut would be split among members. Even if an agreement is reached, we don't expect the deal to be implemented before 1Q17. Until then, we expect OPEC supply to stay high. Meanwhile, non-OPEC supply is expected to rise from 3Q16 to 4Q16. We expect improved supply availability to result in an inventory build in 4Q16. So we remain cautious on oil prices in the short term.
- Rebalancing forces should finally clear the oil market in 2017. Non-OPEC production is already contracting, down by 1.3mbpd y/y in 2Q16 and 1.1mbpd y/y in 2Q16, driven by lower production in the US, China, Mexico and Colombia. Total oil supply is likely to expand by just 0.2mbpd in 2017, similar to this year. Meanwhile, emerging Asia's structural demand growth will continue; we expect global demand to rise by 1mbpd next year versus 1.2mbpd this year.
- We therefore expect significant oil inventory draws in 2H17 and Brent prices at or above USD 55/bbl in 12 months. We therefore like to sell downside protection for a premium versus money market rates, with strikes close to USD 40/bbl.

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

- Prices could rise quicker than expected due to destabilizing geopolitical events in oil-exporting regions like Venezuela, Africa or the Middle East, thus triggering additional outages, a faster contraction in US crude production and/or a full endorsed OPEC production cut. On the demand side, a cold winter could stimulate demand growth.

## ⚡ Negative scenario (Probability: 10%)

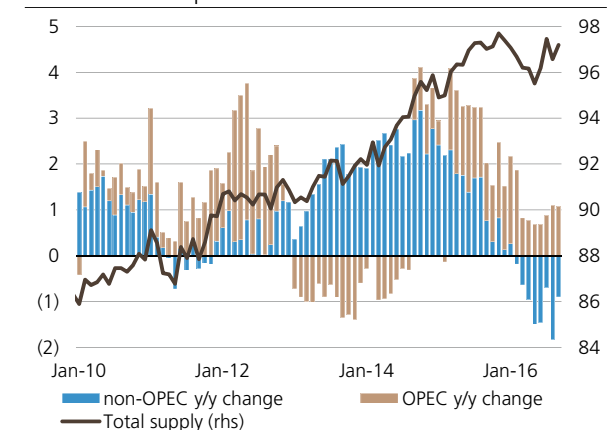
- More resilient non-OPEC production, or fewer OPEC production outages, could keep the market oversupplied. A lasting ceasefire in Nigeria and Libya could result in a return of 1mbpd or more of disrupted supply. Cost reductions and ongoing efficiency gains could lead to more resilient US tight oil production, while the latest oil price increase could moderate US production declines and/or stimulate supply growth early next year. On the demand side, a broader economic crisis in Asia (particularly in China) could slow incremental demand for oil and keep the market in surplus.

## Key dates

<b>Oct 28</b>	OPEC's high committee meeting
<b>Oct 31</b>	US oil supply and demand data for August
<b>Nov 8</b>	EIA short-term energy outlook, providing global demand and supply data
<b>Nov 10</b>	IEA oil market report, providing global demand and supply data
<b>Nov 30</b>	OPEC's ordinary meeting in Vienna

## Total oil supply growth is at a standstill

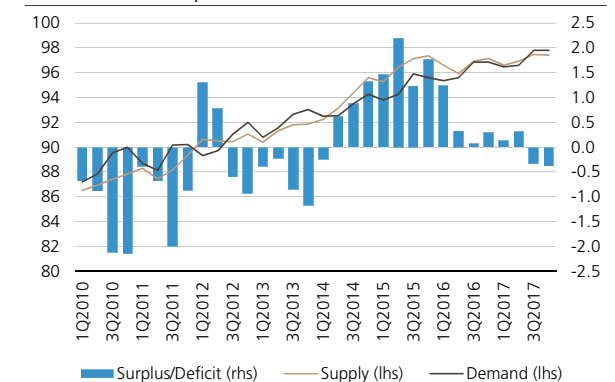
Values are in mbpd



Source: IEA, UBS, as of 12 October 2016

## Global oil demand-supply balance

Values are in mbpd



Source: IEA, EIA, UBS, as of 12 October 2016

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

## Key points

- We expect positive year-on-year S&P 500 EPS growth in 2H16 and 2017.
- Earnings headwinds from depressed oil prices and the strong dollar are fading.
- High profit margins can be sustained.

## CIO view (Probability: 60%)

### Earnings trends improving

- Earnings growth is improving as the huge drags from poor energy sector results and the strong dollar begin to dissipate. Earnings fell 6% in 1Q but only 2% in 2Q. We look for growth to turn positive after more than a year of flat-to-down earnings. We are currently expecting an increase of 3% in 3Q.
- Excluding the energy sector, 1Q16 was the only quarter over the past two years with negative year-on-year earnings (down just 1%). S&P 500 EPS ex-energy grew by 3% in 2Q and we expect 5-6% growth in 3Q.
- With trends stabilizing in emerging markets and the US manufacturing sector, earnings excluding the distortions from the energy sector and the dollar are also brightening as the US economic expansion continues.
- 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 S&P 500 EPS of USD 120 (+1.5%) in 2016 and USD 130 (+8%) in 2017.

## ➤ 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 experience meaningful gains. Increased confidence in the global economic expansion could spur greater capital investment, improving the outlook for industrials. Regardless of the November presidential election outcome, tax reform momentum is expected to 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

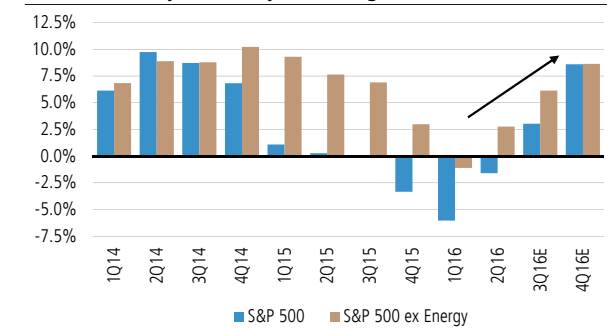
- A downturn in US and global growth could lead to weaker-than-projected revenues for S&P 500 companies. Wage pressures, unaccompanied by improving consumer and business demand, could pressure profit margins and earnings growth rates. Persistently low short-term interest rates and continued declines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

## Key dates

**Oct 24** The busiest week of third-quarter earnings season

## Earnings growth is rebounding

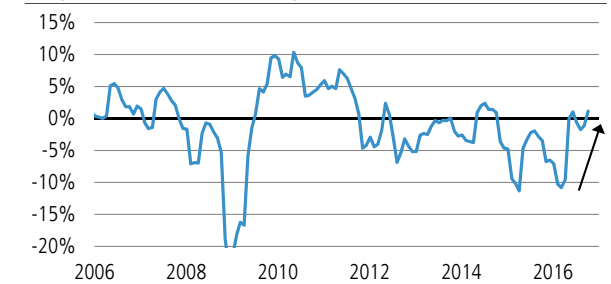
S&P 500 EPS, year-over-year change



FactSet and UBS, as of 13 October 2016

## Earnings revisions have improved substantially

Percent of analyst EPS estimate changes that are positive (negative), 3-month average



DataStream and UBS, as of 13 October 2016

# Global economic outlook - *Summary*

## Key points

- Global growth has offered positive surprises and should continue to be supportive. Domestic demand supports the US and Europe, but is less helpful in Asia. Sentiment data is volatile, but this may reflect political noise not economic sentiment.
- Central bank language suggests a growing realization of the costs of negative interest rates. Further use of this policy seems unlikely. The market focus is on the likely tightening of US monetary policy in December and ECB tapering prospects.
- Oil base effects have not impacted inflation to the magnitude that was anticipated, although the timing of such effects is never precise. Local inflation circumstances create significant divergence.

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

### Broadly stable growth, frequent revisions

- The world produces slightly-below-trend growth, with relative divergence amongst OECD economies and the gap between developed and developing economies unlikely to widen meaningfully.
- US growth continues to focus on the consumer, with the strength of the labor market and a stable credit environment proving especially supportive. European growth is more divergent, but stronger labor markets and higher wage settlements in northern Europe are helpful for growth. Chinese growth is kept near to 6.5% through the injudicious application of credit (housing and its indirect effects remain a key focus for policy).
- Headline inflation rates in the developed world are gradually rising as oil base effects are removed from the year-on-year calculation. US inflation is in line with its 20-year average on most non-oil measures.
- The US Federal Reserve should raise rates in December and continue its very slow quantitative policy tightening. We expect the ECB to continue buying bonds after April 2017, either at the current pace of Euro 80bn per month or less. A tapering in 2017 is our base case. The Bank of England could delay further easing until it sees the impact of its most recent measures.

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

### Return to above-trend growth

- The US economy grows above 2.5%, spurred by robust consumer spending. Political risks fade in the Eurozone and growth and inflation from the European periphery beat forecasts.
- Emerging markets see stable domestic demand and higher commodity prices support exporters.

## ↘ Negative scenario (Probability: 15%\*)

### Global growth disappointments

- The Eurozone's growth outlook deteriorates as bank lending reverses, undermining domestic demand. Economic disappointments push the ECB to ease monetary policy further than is currently expected.
- China's economy weakens on poor investment and manufacturing. Worsening global liquidity conditions lead to funding stress for emerging markets. Global political risks rise as populism presents an increasing challenge to the economic status quo.

\*Scenario probabilities are based on qualitative assessment.

## Key dates

<b>Nov 2</b>	US FOMC decision
<b>Nov 3</b>	US employment report
<b>Nov 8</b>	US presidential, Congressional and state and local elections
<b>Nov 8</b>	China trade balance (October)
<b>Nov 15</b>	UK CPI and RPI inflation (Oct)

## Global growth broadly stable in 2016

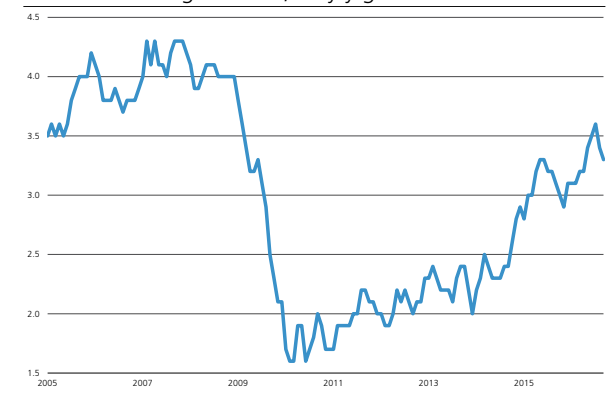
		Real GDP growth in %			Inflation in %		
		2015	2016F	2017F	2015	2016F	2017F
Americas	US	2.6	1.4	2.4	0.1	1.3	2.2
	Canada	1.1	1.2	2.3	1.1	1.5	1.8
	Brazil	-3.8	-2.8	1.6	10.7	6.9	4.7
Asia/Pacific	Japan	0.6	0.5	1.2	0.8	-0.2	0.5
	Australia	2.5	2.8	3.0	1.5	1.2	1.8
	China	6.9	6.6	6.3	1.4	1.9	2.0
	India	7.6	7.4	7.6	4.9	5.4	4.5
Europe	Eurozone	1.6	1.5	1.3	0.0	0.3	1.5
	Germany	1.5	1.4	1.1	0.1	0.3	1.6
	France	1.2	1.4	1.4	0.4	0.2	1.5
	Italy	0.6	0.9	0.9	0.1	0.1	1.6
	Spain	3.2	2.8	1.9	-0.6	-0.4	1.7
	UK	2.3	1.3	0.5	0.0	0.8	3.4
	Switzerland	0.8	1.4	1.3	-1.1	-0.3	0.4
<b>World</b>		3.2	2.9	3.3	2.7	2.7	2.8

Source: UBS, as of 20 October 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.

## US wage growth remains strong, supporting consumption

### Atlanta Fed Wage Tracker, % y/y growth



Source: Atlanta Federal Reserve via Haver, UBS, as of 13 October 2016

# US economy - *Moderate growth in the US*

## Key points

- We expect the US economy to grow at a moderate pace over the next 12 months.
- Inflation should gradually trend higher as the recovery continues.
- We expect the Federal Reserve 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 at 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, although the worst appears to be over.
- 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, inflation should gradually trend higher with the tightening labor market.
- On the fiscal side, major policy reforms are unlikely until after the new president takes office in January. Fiscal policy is likely to become at least somewhat looser following the election.
- With progress being made toward the Fed's dual mandate of full employment and price stability, we expect a 25bps rate hike in December.

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

### Strong expansion

- US real GDP growth rises above 2.5%, propelled by accommodative monetary policy, strong household spending and subsiding risks overseas. The Fed raises policy rates far 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 for the next 12 months.

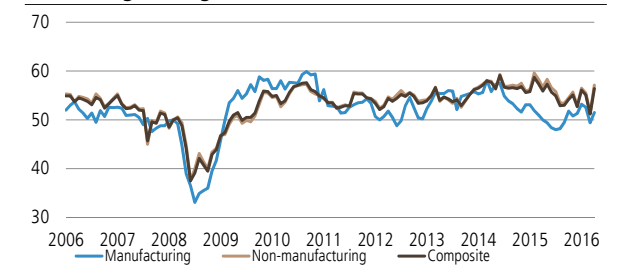
\*Scenario probabilities are based on qualitative assessment.

## Key dates

<b>Oct 28</b>	GDP for 3Q16
<b>Oct 31</b>	Personal income and spending for September
<b>Nov 4</b>	Labor market report for October
<b>Nov 8</b>	Election day

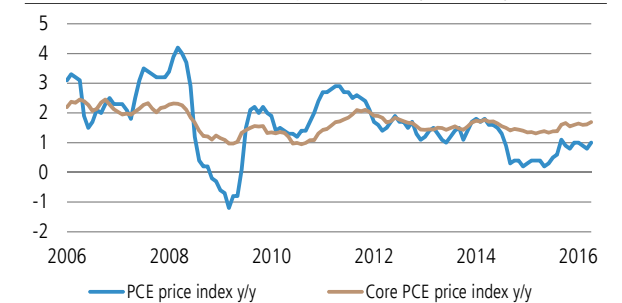
## PMIs rebounded in September

### 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 growth*

## Key points

- We expect economic growth to remain solid despite global disruptions like the UK's vote to leave the EU.
- Inflation should continue to quickly rebound until the winter.
- The ECB has been in wait-and-see mode since the UK referendum and will intervene if needed.

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

### 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 continue rising 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 it is ready to act if needed. We expect the ECB to continue buying bonds after March 2017 - EUR 80bn per month or less. Our base case is a tapering of QE in 2017.
- In Germany, fundamentals such as consumer confidence, construction 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 corporate investments are helping solidify growth.
- Italian economic growth should consolidate at low rates, supported by a stabilizing 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: 20%\*)

### Deflation spiral

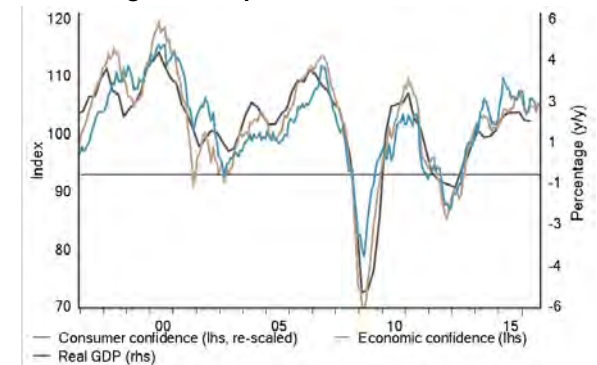
- The Eurozone slips into a deflationary spiral due to a shock, such as Greece leaving the Eurozone, a sharp escalation in the Ukraine conflict or China suffering a severe economic downturn.

\*Scenario probabilities are based on qualitative assessment.

## Key dates

<b>Oct 24</b>	Eurozone PMIs first estimate (October)
<b>Oct 31</b>	CPI estimate (October), GDP first estimate (3Q)
<b>Nov 3</b>	Unemployment rate (September)
<b>Nov 23</b>	Eurozone PMIs first estimate (November)
<b>Dec 8</b>	ECB press conference

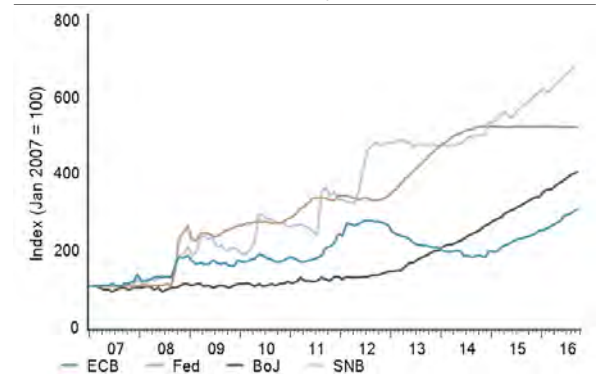
## Eurozone growth expected to remain solid



Source: Haver Analytics, UBS, as of September 2016

## ECB balance sheet boosted by QE and TLTROs

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



Source: Haver Analytics, UBS, data as of September 2016 (SNB, as of August 2016)

# Chinese economy - *Orderly deceleration in China*

## Key points

- China is striking a balance between maintaining economic stability and implementing mild reforms. GDP growth continues its orderly deceleration.
- We expect consumer price inflation (CPI) to grow mildly and PPI inflation to improve.
- We expect both fiscal and monetary policy to stay accommodative in order to maintain economic and financial stability.

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

### Balance between economic stability and mild reforms

- The Chinese economy will continue its orderly deceleration as the central government balances between maintaining economic stability and implementing mild reforms. China's 1H16 GDP grew by 6.7% y/y, a record low since the 2009 financial crisis, and will continue to decelerate amid deep adjustments in the old economy.
- Falling investment will continue while being dragged down by manufacturing and real estate. Fixed asset investment (FAI) growth from January to August slowed to 8.1% y/y from 9.0% in 1H16. Notably, private investment growth, accounting for over 60% of total FAI, decelerated to 2.1% y/y in August from 2.8% in 1H16 (10.1% in 2015); slowing private investment growth is ranked as a top risk in China.
- Retail sales should continue to decelerate mildly. August retail sales growth edged up to 10.6% y/y from 10.3% in 1H16, but downward pressure is expected for 2H16.
- Exports continue to face downward pressure; we expect a single-digit contraction in 2016. Exports in September slid -10.0% y/y from -2.8% y/y in August on weak external demand and the CNY's depreciation. This shows that a mild currency depreciation does little to help labor-intensive exports.
- CPI inflation should rise mildly and PPI inflation is expected to improve. September CPI inflation edged up to 1.9% y/y because of food prices, while September PPI inflation rose to 0.1% y/y, the first positive reading since March 2012.
- Fiscal policy, especially local fiscal spending on infrastructure, remains the major buffer of an economic downturn. However, the highly-expected tax and fee deductions have been postponed.
- Monetary policy will remain accommodative. China's central bank prefers liquidity injections via open market operations and lending facilities. Additional reserve requirement ratio and interest rate cuts are unlikely.

## ↗ Positive scenario (Probability: 5%\*)

### Growth acceleration

- China's GDP growth rises above 7%, pushed up by strong government policy stimulus packages and/or a strong pick-up in external demand.

## ↘ Negative scenario (Probability: 15%\*)

### Sharp growth downturn

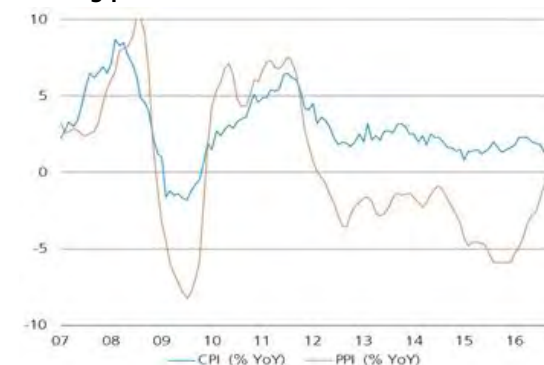
- Economic growth abruptly turns lower, falling below 6% real GDP growth for more than two quarters, due to a sharper-than-expected fall in investment accompanied by widespread credit defaults.

\* Scenario probabilities are based on qualitative assessment.

## Key dates

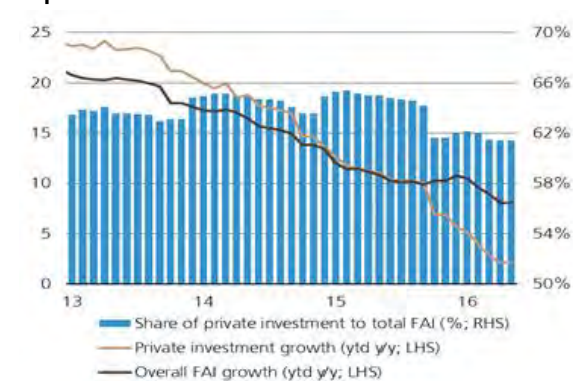
Nov 1	PMI manufacturing index
Nov 14	FAI, retail sales, industrial output for October

## China's CPI inflation to stay mild with PPI inflation turning positive



Source: CEIC, UBS, as of 18 October 2016

## Plunging private investment growth has become a top risk in China



Source: CEIC, UBS, as of 18 October 2016

# Swiss economy - *Recovering, but not out of the woods*

## Key points

- Switzerland's economy is likely to continue its recovery in 2H16 as Swiss companies learn to deal with the strong CHF.
- The UK's decision to leave the EU has increased economic uncertainty and may exert a drag on Swiss growth via slowing demand from Europe. We therefore expect Switzerland to recover at a slower pace in the coming quarters than in 1H16.
- If necessary, the Swiss National Bank will try to prevent a sharp appreciation of the franc by: 1) intervening in the FX market; and 2) cutting the target rate if interventions don't suffice.

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

### Moderate recovery

- The Swiss economy grew at 0.6% q/q in 2Q16. Growth was also revised up for the last few quarters, pointing to robust growth in the last 12 months. We have revised up our forecast for 2016 GDP growth to 1.4%.
- However, the GDP data is at odds with employment, which shows a year-on-year drop in jobs in 1H16. We therefore think Swiss companies are still adapting to the strong Swiss franc; this adjustment process is painful and may be a drag on activity in 2H16. We only expect a sustainable recovery next year when Swiss exporters have completely adapted to the strong franc.
- The manufacturing PMI continued to trend up in September and points to a rebound of growth at the beginning of 4Q16.
- CPI inflation remained in negative territory in September. It is expected to recover in the coming months as the effects of the weaker oil price and the stronger franc fade.
- The main goal of the Swiss National Bank (SNB) in the short term is to prevent the franc from appreciating sharply to safeguard the Swiss economic recovery. To achieve this, the SNB will likely first intervene in the FX market. Only if interventions do not work would it resort to a further rate cut. A rate hike is not on the cards in the next 12 months. The SNB will not have the opportunity to raise rates until the ECB stops its QE program.
- The initiative against mass immigration has to be implemented by February next year. The National Council of the Swiss parliament has decided to implement the initiative in a minimalist way by only establishing a national priority clause (the implementation proposal still has to go through the Council of States). While this implementation may not cause problems with the EU, it could trigger a new initiative by the Swiss People's Party, which could also threaten the bilateral agreements.

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

### Swiss franc shock already digested

- Export growth gathers further momentum as Swiss companies have already fully digested the Swiss franc shock.

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

### Stagnating Swiss economy in the coming months

- The Swiss recovery stalls, with demand from Europe falling off a cliff as the medium-term impact of Brexit on the real economy is stronger than currently indicated by leading indicators.

\* Scenario probabilities are based on qualitative assessment.

## Key dates

<b>Oct 27</b>	UBS Consumption Indicator for September
<b>Nov 1</b>	Manufacturing PMI for October
<b>Nov 7</b>	CPI for October
<b>Nov 8</b>	Unemployment for October

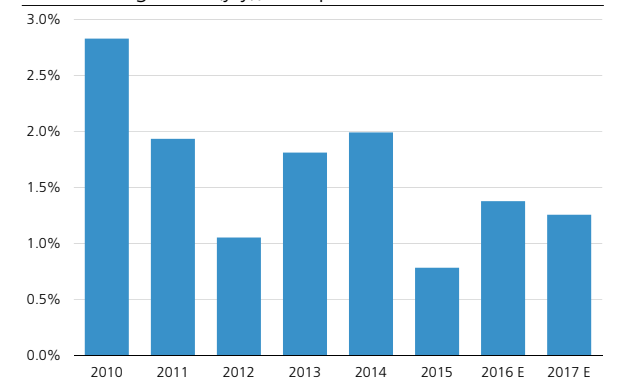
## Swiss PMI rebounded from the Brexit shock



Source: procure.ch, UBS, as of 13 October 2016

## Swiss GDP growth overcoming CHF shock

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



Source: Seco, UBS, as of 15 October 2016



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