UBS

Global Perspectives

Multi Asset | February 28, 2017

Overview

Equities: There were signs that growth is accelerating as broad global economic data have steadily reported positive news. Against this background, global equity markets continued to rise in February, with developed markets significantly outperforming emerging markets—US equity markets in particular. European equities and emerging market equities both posted small but positive returns (local returns).

Fixed income: Sovereign fixed income rebounded after a difficult January with developed markets yields falling significantly. Credit markets were generally positive as well. In the high yield universe, US credit spreads significantly tightened and produced especially strong returns for the month.

Currency: Mexican peso appreciation was strong in February as Banco de Mexico hiked interest rates and announced currency intervention measures to limit the depreciation of the peso. The New Zealand dollar weakened as the Reserve Bank of New Zealand advised that they are not expecting to hike rates this year.

The month in review:

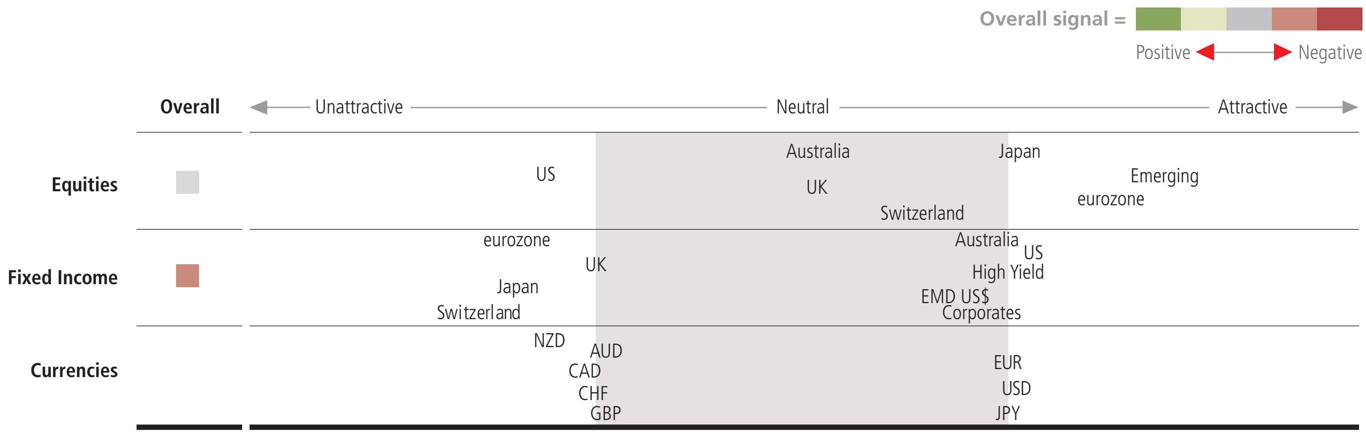
- A more subdued tone to political activity in February meant most global markets adopted something of a wait-and-see mode during the month.
- Global markets have now shifted their attention towards the possibility of a Federal Reserve (Fed) increase in interest rates occurring later in March. With a strong economic tailwind, it is becoming clearer that many Fed policymakers believe that there is no need to wait for President Trump's fiscal package details before tightening monetary policy.
- Political risk in Europe remains at the forefront of investors' minds. Nationalist and Eurosceptic French presidential candidate Marine Le Pen continues to lead first-round polling. While polls predict clear defeat in the second round, the shocks seen in 2016 mean fears remain of another "black swan" political outcome. Purchasing manager index (PMI) readings for the eurozone unexpectedly improved relative to the US.
- Economic data in China and Japan were also more positive, with Japan recording four consecutive positive quarters of growth in 2016.
- Sovereign fixed income rebounded after a difficult January with developed markets yields falling significantly. This was most pronounced within UK Gilts after a vote passed to allow the UK Prime Minister Theresa May to get Brexit negotiations under way with Parliament at the beginning of the month. Returns within credit markets were generally positive as well. In the high yield universe, US credit spreads significantly tightened and produced especially strong returns for the month.

Outlook:

- While data supports a continued improvement in the US economic outlook, a high level of uncertainty remains around President Trump's policies and the scale of fiscal action is likely to remain constrained by budgetary realities. In terms of positioning, we are currently taking a small overweight to global equities, while retaining a small underweight to global duration in general terms.
- Outside of the US, we see more attractive valuations and the improving growth backdrop as broadly supportive to equities. In Europe, we continue to believe that the European recovery story is, finally, gathering momentum—supported in no small part by the European Central Bank's (ECB) loose policy and a weak euro. While geopolitical risks are clearly high ahead of major elections in a number of core eurozone countries, we see these risks as well flagged and, to a degree, already reflected in valuations.
- Against a backdrop of accelerating demand growth in the US, we see President Trump's campaign promises of lighter regulation for the energy sector as a positive for US high yield, in particular, where oil companies are a significant part of that universe. On a relative basis, we believe that more domestically biased high yield issuers are greater beneficiaries of the President's pro-growth "America First" agenda than more internationally diverse US investment grade borrowers.

Current views[1]

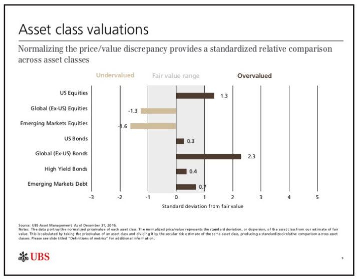
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities	Negative	• Our analysis shows the broader US equity market as overvalued in a historical context. • While President Trump's pro-growth rhetoric and policy promises of lighter regulation, lower taxes, increased fiscal spending and "America First" trade deals are all potentially supportive to domestic growth and, therefore, corporate earnings, we believe that the market has now run ahead of itself. There are risks both to the timing and scale of President Trump's tax cuts and infrastructure spending. It is unlikely that tax cuts will progress until this potentially complex legislative issue is resolved. With inflationary forces rising, there is also a risk that the Fed will raise interest rates more aggressively than investors currently expect. • Within US equities we continue to prefer more attractively rated "value" stocks over the wider market and see key support from a gently inflationary backdrop.
Global (Ex-US) Equities	Slightly positive	• Outside of the US, we see attractive valuations and the improving growth backdrop as supportive to equities. In Europe, we continue to believe that the European recovery story is finally gathering momentum—supported in no small part by the ECB's loose policy and a weak euro. While geopolitical risks are clearly high ahead of major elections in a number of core eurozone countries, we see these risks as well-flagged and to a degree, already reflected in valuations.
Emerging Markets Equities	Positive	• Emerging markets (EM) equities have looked attractively valued on our analysis for some time. • We believe post-US election fears about the impact of a stronger USD and wider trade protectionism risks are overdone and more than reflected in valuations in some markets. We see the US dollar (USD) as late cycle and do not believe that a strong USD will derail the improvement in overall demand momentum in EM or the earnings upgrade story. • Moreover, we see the potential boost to US growth from an increase in infrastructure spending and lower tax rates as positives for demand growth in EM.
US Bonds	Neutral	• While structural deflationary forces, including aging populations, are likely to act as a rebalancing mechanism to significantly further U.S. Treasury yield rises in the medium term, there are still risks of shorter-term upside inflationary surprises due to commodity price rises and stronger-than-expected wage growth. Against this backdrop we, therefore, continue to retain a positive view of inflation-linked U.S. Treasuries. • However, after the recent rise in yields, we also see nominal U.S. Treasuries as offering attractive carry on a relative basis globally (particularly versus German bunds).
Global (Ex-US) Bonds	Slightly negative	• In aggregate, we see global bonds outside of the US as unattractive. German bunds are particularly expensive relative to their long-term history on our analysis. • We have a preference for Canadian bonds which we see as an attractive hedge for lower oil prices given the importance of energy to the Canadian economy. We also believe that the Canadian economy has a long process of restructuring ahead as its reliance on the energy sector diminishes. In our view, the diverging fortunes of provinces make monetary policy very difficult for the Bank of Canada.
Investment Grade Corporate Debt	Slightly positive	• Our positive view on investment grade bonds (IG) relative to developed world sovereign debt is largely predicated on the former's attractive yield pick-up. We see global demand for yield continuing to support IG. With a sharp rise in defaults at the higher-quality end of corporate debt unlikely—given the improving demand backdrop, balance sheet strength and generally loose monetary policy, we see global IG corporates as continuing to offer an attractive risk-and-return profile compared with government bonds.
High Yield Bonds	Slightly positive	• Against a backdrop of accelerating demand growth in the US, we see President Trump's campaign promises of lighter regulation for the energy sector as a positive for US High Yield, where oil companies are a significant part of that universe. On a relative basis, we believe that more domestically biased high yield issuers are greater beneficiaries of the President's pro-growth "America First" agenda than more internationally diverse US investment grade borrowers.
Emerging Markets Debt US dollar Local currency	 Neutral Slightly positive	• Our overall view on both local and external emerging markets government bonds remains neutral. We believe a subset of currencies within this broad universe now look attractive on a long-term basis, while the improvement in current accounts and broader economic growth now broadly balance the risks from high debt levels.
Currency		• Among developed market currencies we see ongoing support for the euro, while we view the Swiss franc as among the most expensive currencies globally on our long-term analysis. • In emerging markets, we retain a constructive view on a number of currencies including the Mexican peso and Indian rupee. We believe the New Zealand dollar is significantly overvalued in a long-term context.

[1] Source: UBS Asset Management. As of February 28, 2017.

Valuations plus one or more market behavior indicators provide an overall signal



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Market themes	Momentum and flow
Market stress	Macroeconomic landscape

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Overall signal

Market themes	Momentum and flow	Market stress	Macroeconomic landscape
Market opportunities that we believe will drive markets in the longer term but have an immediate impact. This helps put valuation into context. For example: "European debt crisis," "aging population" or "deleveraging."	Attempts to capture money flows and market appetite for risky assets from the perspective of professional asset allocators, such as mutual fund managers.	We created a proprietary stress index to help gauge price dislocations and investor risk appetite. It comprises several spread measures across credit markets, currencies and cash markets, as well as measures of market sentiment, such as the Chicago Board Options Exchange Market Volatility Index (VIX).	Understanding the current position (recovery, expansion, slowdown, recession) in the economic cycle of a country or region. We also consider the baseline and alternative economic scenarios of countries and regions and how asset classes may react differently in these scenarios.

US Equities example as of February 28, 2017

Valuation and market behavior indicators at work

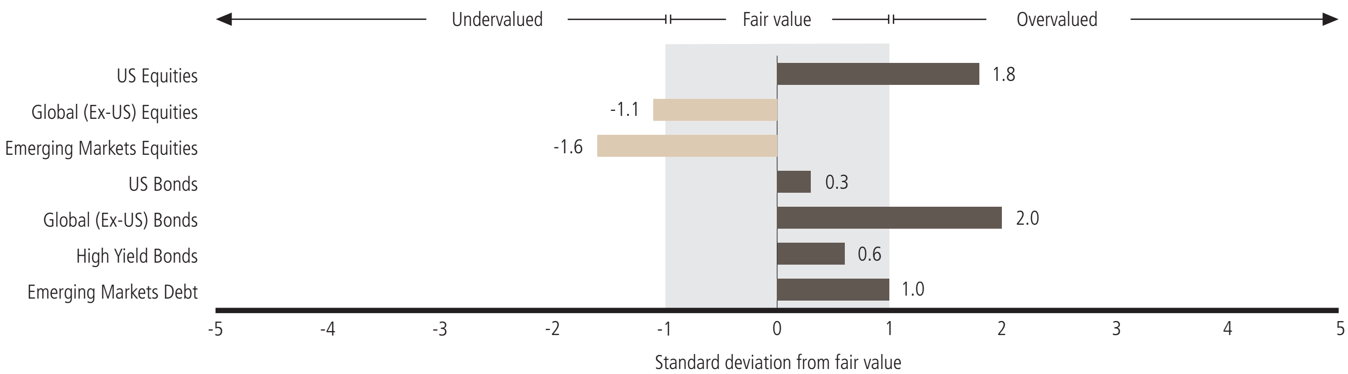
Overall signal =

Valuation	+	Market themes	+	Momentum and flow	+	Market stress	+	Macroeconomic landscape	=	Overall signal
Slightly negative		Slightly negative		Slightly negative		Slightly positive		Slightly positive		Negative

Note: The contribution each component has to the overall signal will vary from month to month.

Normalized asset class valuations[2]

Normalizing the price/value discrepancy provides a standardized relative comparison across asset classes



[2] Based on UBS Asset Management's views. As of February 28, 2017.

Definitions of metrics:

1. **Asset Class/Benchmark:** All investment expectations displayed here are modeled from the discounted cash flows as replicated by the relevant publicly available index. This bears mentioning because these expectations are developed assuming no benefit from active management (i.e. security selection) within the asset classes themselves.

2. **Price/Value:** An intrinsic value based on the cash flows that an asset class provides—discounted at an appropriate rate of return (the required rate of return)—is identified for each of the asset classes listed. The cash flows would be those that would be expected to pass through to the asset holder; in the case of equities, the relevant cash flows are earnings and non-reinvested earnings (including, though not exclusively, dividends). That intrinsic value is then compared to the market price for the proxy index, and the degree of over- or undervaluation is thereby calculated in percent.

3. **Normalized Price/Value:** The normalized price/value represents the standard deviation, or dispersion, of the asset class from our estimate of fair value. Normalizing the price/value discrepancy provides a standardized relative comparison across asset classes. The normalized price/value is calculated by taking the price/value of an asset class and dividing it by the secular risk estimate of the same asset class.

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