UBS

# Global Perspectives

## Multi Asset | March 31, 2017

**Overview**

**Equities:** Global equity markets extended their first-quarter gains further this month, supported by strong global manufacturing data that suggests that economic momentum continues to improve in both developing and emerging markets.

**Fixed income:** Fixed income returns were mixed during March. There were positive returns within UK index-linked bond markets, which were supported by inflation sharply rising above the Bank of England's target for the first time since 2013. US high yield assets experienced widening spreads due to significant weakness in oil markets. US and UK investment grade (IG) spreads slightly widened while European IG spreads tightened.

**Currency:** The Mexican peso continued its rally driven by more positive rhetoric on future trade ties from the US administration, as well as a dovish hike from the Federal Reserve (Fed), which resulted in a weaker US dollar. Strong economic data out of Australia caused their dollar to appreciate against some currencies, such as the New Zealand dollar.

### The month in review:

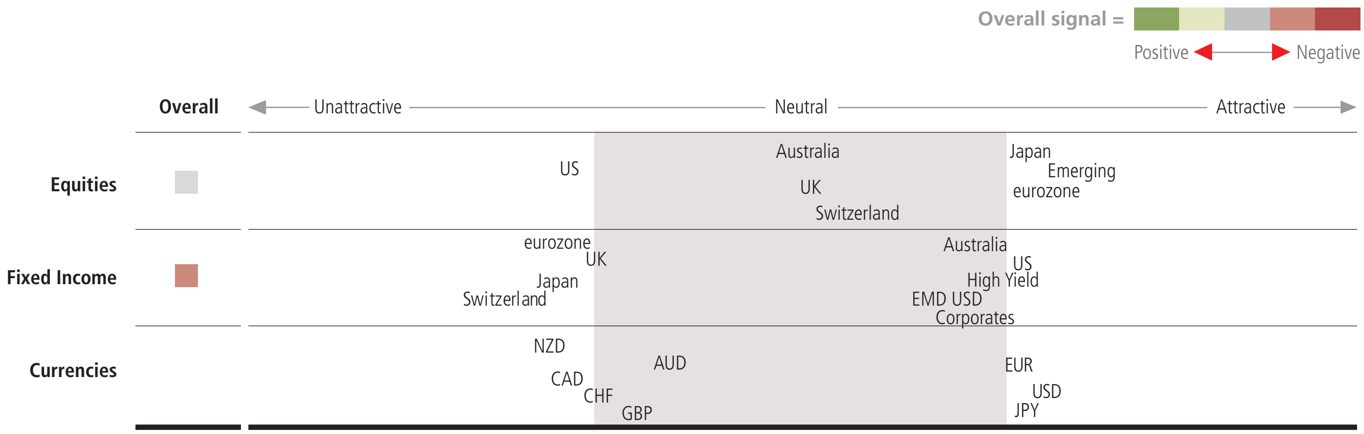
- The end of March marked the start of at least two years of extraordinary uncertainty as the United Kingdom formally began the process of withdrawing from the European Union.
- The Fed announced an expected quarter-point increase in interest rates—the third hike since the start of the current hiking cycle. This was accompanied by chairperson Janet Yellen signalling an accelerating pace of rate hikes throughout 2017, which was subsequently echoed by other key Fed policymakers.
- Global equity markets extended their first-quarter gains further this month. European equities paved the way, driven by the rejection of anti-euro politicians in both Austria and the Netherlands. US equities posted small positive returns, in contrast to February, despite labor market data coming in ahead of expectations. The laggard amongst major markets was Japan, where equity markets delivered negative returns.
- Fixed income returns were more mixed during March. There were positive returns within UK index-linked bond markets, which were supported by inflation rising sharply above the Bank of England's target for the first time since 2013. Within credit markets, US high yield assets saw widening in spreads due to significant weakness in oil markets. In the investment grade universe, US and UK spreads slightly widened while European spreads tightened.

### Outlook:

- While data supports 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 of equities. In Europe, we continue to believe that the European recovery story is gathering momentum. Initially supported by the European Central Bank's (ECB) loose policy and a weak euro, along with bank balance sheet restructuring now largely over, we view the recovery as increasingly self-sustainable. Despite the Dutch election result, geopolitical risks remain high ahead of major elections in core eurozone countries, with the first round of the French presidential elections taking place in April. We see these risks as well flagged and, to a degree, already reflected in valuations.
- While structural deflationary forces, including aging populations, are likely to act as a rebalancing mechanism to significant 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, we also see nominal U.S. Treasuries as offering attractive carry on a relative basis globally and particularly versus German bunds.

## Current views[1]

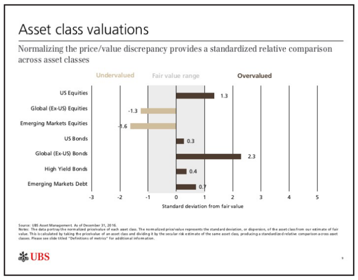
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis




| Asset Class | Overall signal | UBS Asset Management's viewpoint |
|---|---|---|
| **US Equities** | | • Our analysis shows the broader US equity market as overvalued in a historical context. The key question is whether the outlook for earnings has increased sufficiently to justify the post-election equity rally. Trailing earnings are no higher than they were two years ago, and on a forward-looking basis we estimate US earnings to be above their cyclically adjusted normal levels. The answer, therefore, would appear to be that US equities are expensive at current levels and with expectations elevated, vulnerable to any disappointment.<br>• With inflationary forces rising, we believe there is also a risk that the Fed raises interest rates more aggressively than investors currently expect.<br>• 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** | | • Outside of the US, we see attractive valuations and the improving growth backdrop as supportive to international equities. In Europe, we continue to believe that the European earnings recovery story is gathering momentum. Initially supported by the ECB's loose policy and a weak euro, along with bank balance sheet restructuring now largely over, we see the recovery as increasingly self-sustainable. 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. Attractive valuations also support a constructive view of Japanese equities. |
| **Emerging Markets Equities** | | • Emerging market (EM) equities have looked attractively valued on our analysis for some time.<br>• We believe that post-US election fears about the impact of a stronger USD and wider trade protectionism risks have been overdone. Thus far, at least, investors' worst fears about President Trump's trade policy have not materialized. 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 for EM or the earnings upgrade story.<br>• Moreover, we see the potential boost to developed world growth from an increase in infrastructure spending and lower tax rates as positives for demand growth in EM. |
| **US Bonds** | | • While structural deflationary forces, including aging populations, are likely to act as a rebalancing mechanism for significant 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.<br>• However, after the recent rise in yields, we also see nominal U.S. Treasuries as offering attractive carry on a relative basis globally and particularly versus German bunds. |
| **Global (Ex-US) Bonds** | | • 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.<br>• 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** | | • Our positive view on IG bonds 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** | | • We see accelerating demand growth and deregulation in the US as positive for corporate cash flows and balance sheets and, therefore, positive for US High Yield. On a relative basis, we also 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**<br>US dollar<br>Local currency | | • We retain a neutral view of external emerging market government bonds. We have a more positive view of local currency EM debt. 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.<br>• In emerging markets we have recently taken partial profits in the Mexican peso after a strong run and retain a constructive view on a number of EM currencies including the Indian rupee. We believe the New Zealand dollar is significantly overvalued in a long-term context. |

[1] Source: UBS Asset Management. As of March 31, 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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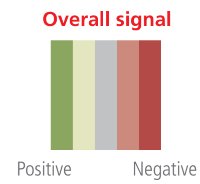



### Market themes

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."

### Momentum and flow

Attempts to capture money flows and market appetite for risky assets from the perspective of professional asset allocators, such as mutual fund managers.

### Market stress

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).

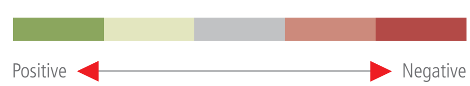
### Macroeconomic landscape

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 March 31, 2017

Valuation and market behavior indicators at work

Overall signal =

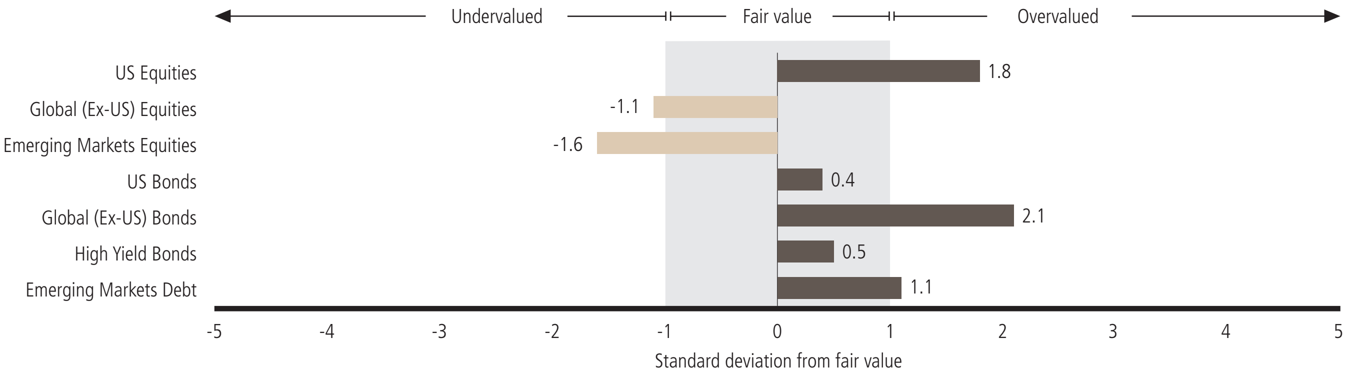



| Valuation | + | Market themes | + | Momentum and flow | + | Market stress | + | Macroeconomic landscape | = | Overall signal |
|---|---|---|---|---|---|---|---|---|---|---|
| Slightly negative | | Slightly negative | | Neutral | | Neutral | | Slightly negative | | Negative |

**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 March 31, 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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