UBS

December 2015
Asset management research

Global Asset Views

Economic and market developments in perspective

Formulating our global asset views

Assessing the global economic and market environment is a key part of the investment strategy-setting process across UBS Asset Management. We believe that debate between specialists from different parts of the business allows each investment team to gain a thorough understanding of the economic and market drivers affecting the asset class in which they invest. It also helps enhance the thinking behind and inputs into our range of investment strategies.

Cyclical Market Forum
To foster this exchange of views, we host a quarterly Cyclical Market Forum (CMF), which is attended by representatives from all of our investment areas: Multi-Asset, Fixed Income, Equities, Real Estate and Hedge Funds.

The starting point for debate at the CMF is global economic scenario analysis over a 12- to 18-month time horizon. In advance of the forum, attendees submit their views on topical investment issues as well as developments specific to their asset class, and allocate probabilities to each of three potential global economic scenarios.

Output from the CMF is used in different ways by the various investment teams, and represents only one of many inputs into the investment strategy-setting process. The strength of the forum lies in its ability to facilitate structured analysis of both the top-down and bottom-up drivers of returns for all asset classes on a regular basis.

Global Asset Views – Economic and market developments in perspective
This quarterly Global Asset Views publication covers the CMF held in December 2015. It outlines the three global economic scenarios analysed by attendees at the CMF and the probabilities allocated to each, as well as focusing on their potential impact on the various asset classes. It then showcases the current asset allocation and currency views of our Multi-Asset team. For the first time, the views of the Global Real Estate team also feature this quarter.

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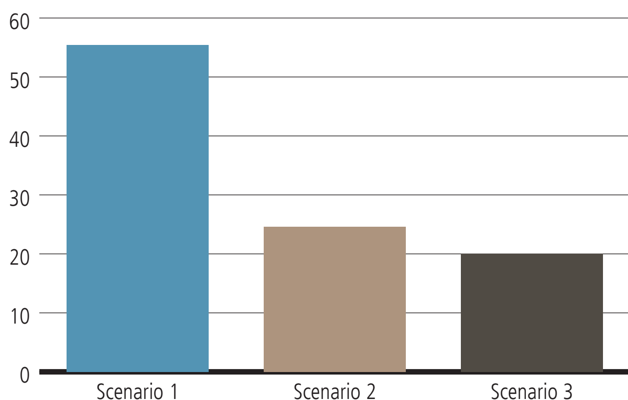
CMF December 2015: Voting patterns

The exchange of views between representatives of our Multi-Asset, Fixed Income, Equities, Real Estate and Hedge Funds teams at the CMF is structured around analysis of three global economic scenarios. Each investment specialist discusses how the asset class in which they invest would fare under each scenario – consensus (scenario 1), upside surprise (scenario 2) and downside risk (scenario 3). The scenarios differ in their views on growth and inflation over the next 12-18 months for both developed and emerging economies. The key assumptions of each scenario are outlined on page 3.

Charts 1, 2 and 3 on this page illustrate some of the key outcomes of UBS investors' voting on the three global economic scenarios for the December 2015 CMF.

Chart 1: Average probability attributed to each global economic scenario

The overall voting pattern signaled higher belief than in the previous quarter that the consensus scenario 1 would play out (55% in Q4 compared with 52% in Q3). There was a lower degree of pessimism in expectations, with the average percentage allocation to scenario 3 falling to 20%, from 23% previously.

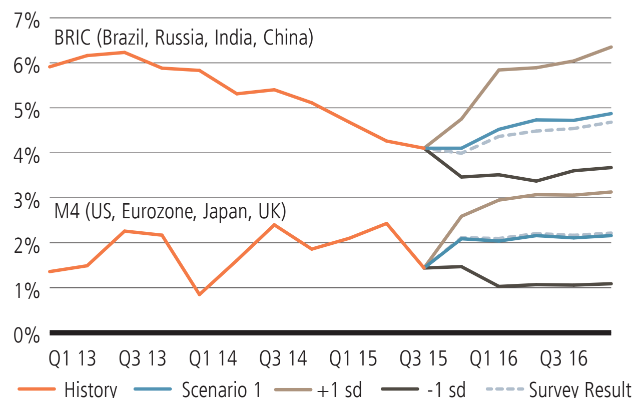


Source: UBS Asset Management, December 2015. The three scenarios are those considered by UBS Asset Management's CMF.

Source: UBS Asset Management, Bloomberg, International Monetary Fund, December 2015. The three scenarios are those considered by UBS Asset Management's CMF. The information is presented as an illustration of the issues discussed during the CMF and is not intended to be a forecast.

Chart 2: GDP growth quarter-on-quarter annualized

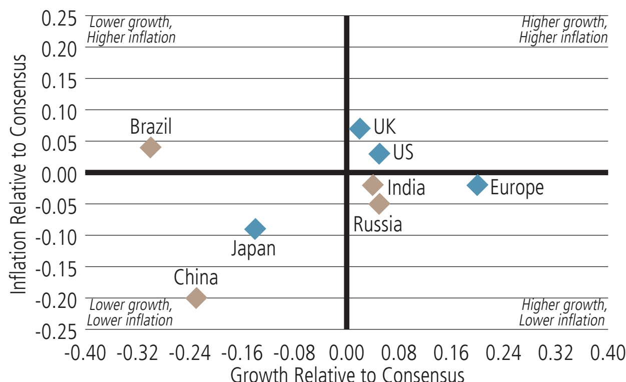
Our investors have grown more concerned about emerging market economies, expecting growth to fall well short of consensus expectations over the next 12 to 18 months. As was the case last quarter, developed economies could grow at a faster-than-anticipated rate.



Source: UBS Asset Management, Bloomberg, International Monetary Fund, December 2015. The three scenarios are those considered by UBS Asset Management's CMF. The information is presented as an illustration of the issues discussed during the CMF and is not intended to be a forecast.

Chart 3: Relative GDP growth and CPI inflation expectations

Relative to consensus, the average UBS investor has grown more positive on the growth outlook for the Eurozone, while the prospects for Japan have deteriorated slightly. In emerging markets, Russia's economic performance is viewed as being on an improving trend, while India remains an area of relative strength. China and Brazil continue to cause our investors concern.



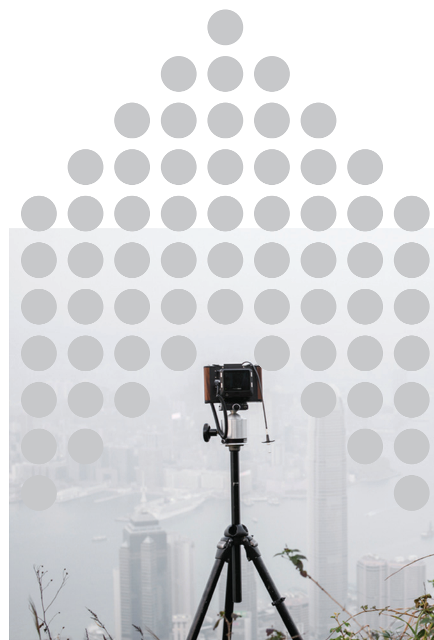
Global economic scenarios

Scenario 1: Consensus (55%)

- The outlook for developed market economies remains broadly unchanged, with activity to expand at a moderate pace in the next 12 to 18 months. In a context where external demand has been struggling given the weakness in emerging markets, domestic demand should remain the main engine of growth in the US, the UK and the Eurozone.
- The outlook for emerging markets has been revised slightly upwards. Nevertheless, growth in the emerging economies is still expected to remain at historically low levels.
- The US economy should continue to expand at a pace close to 2.5%, while the recovery in the Eurozone is expected to gather some momentum, although expanding at a pace below 2% over the next two years. Eurozone domestic demand is supported by low energy costs and loose monetary policy. Net trade is expected to disappoint slightly as the positive effects of a weaker euro are offset by subdued activity in the emerging economies. In Japan, it is anticipated that GDP will expand at a very modest pace this year and next.
- The growth prospects for the emerging economies have slightly improved, albeit from extremely low levels. The pace of economic activity is expected to pick up in the next couple of years, but mostly as a result of Russia and Brazil returning to growth after contracting severely this year. China continues its transition towards a consumption-driven economy, with annual GDP growth expected to fall slightly in the coming years. At the same, the positive momentum in the Indian economy looks likely to continue.

Scenario 2: Upside (25%)

- Federal Reserve normalizes interest rates as US economy strengthens further, leading to resurgent demand and boosting global growth.
- China succeeds in economic reorientation, leading to faster growth which has positive spill-over effect on other emerging market economies, particularly in driving demand.
- As the Eurozone recovery becomes self-sustained, confidence picks up, providing a favorable backdrop for investment spending.
- Larger fiscal stimulus in Japan to offset effects of the hike in value-added tax (VAT).
- Successful implementation of measures to reduce Brazil's fiscal deficit restores investor confidence in government.
- Economic sanctions on Russia are removed, or reduced meaningfully.



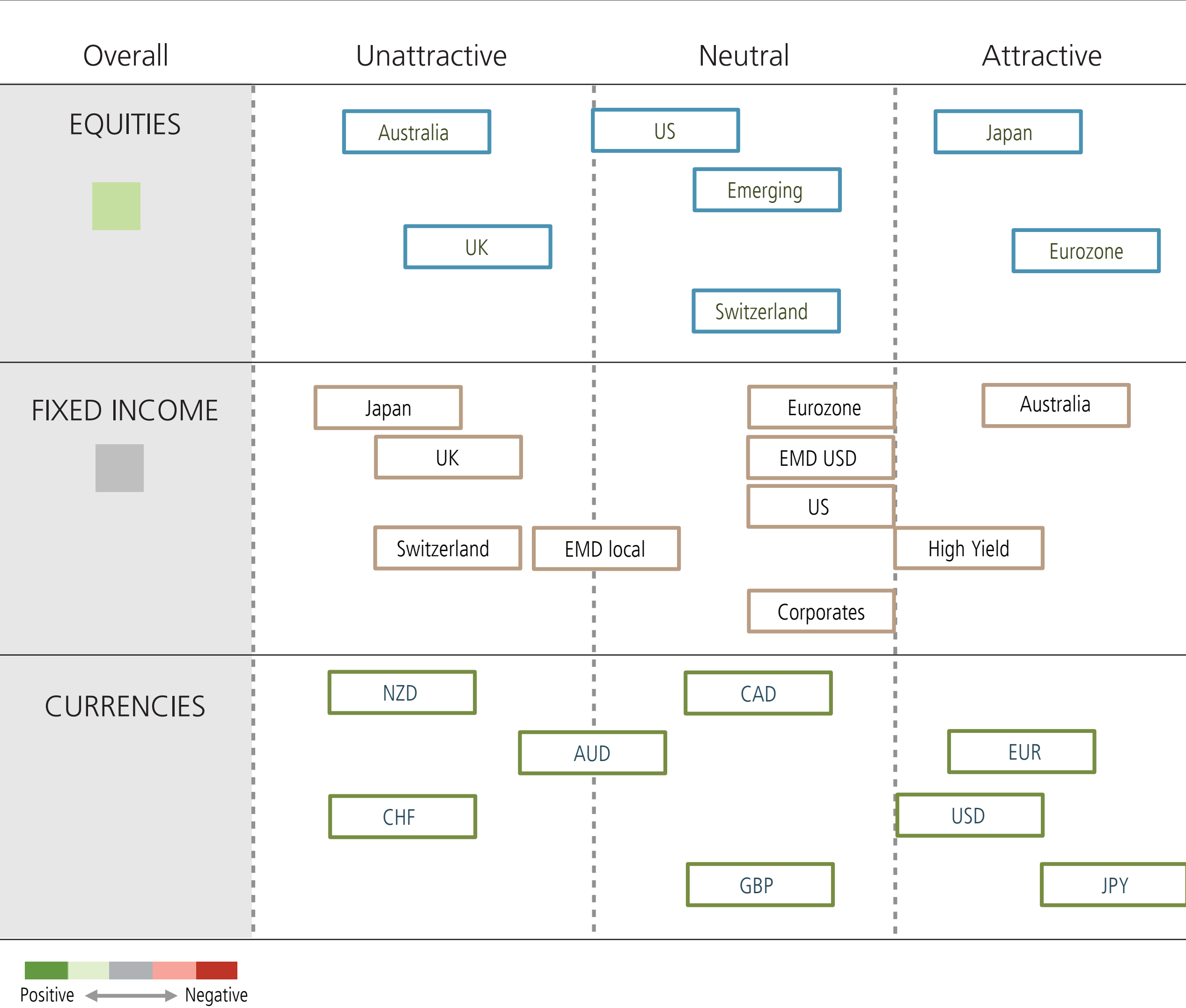
Scenario 3: Downside (20%)

- Pronounced weakness in China and other emerging economies derails the global recovery.
- In China, spill-overs from weakness in industry to other sectors of the economy, weighing on domestic demand in particular.
- Fed interest rate normalization has severe unanticipated consequences, suppressing investor risk appetite.
- Geopolitical and terrorism-related developments have a marked negative impact on the global economy and financial markets.
- US energy sector weakens further, and there is significant spill-over effect on other sectors and broad-based scaling back in capital expenditure.
- Referendum on European Union membership shows that UK voters want to leave.

Global asset views Q4 2015

The chart below shows the GIS Asset Allocation and Currency team's views on overall asset class attractiveness, as well as relative attractiveness within equities, fixed income and currencies, as of 30 November 2015.

Chart 4: Asset class attractiveness

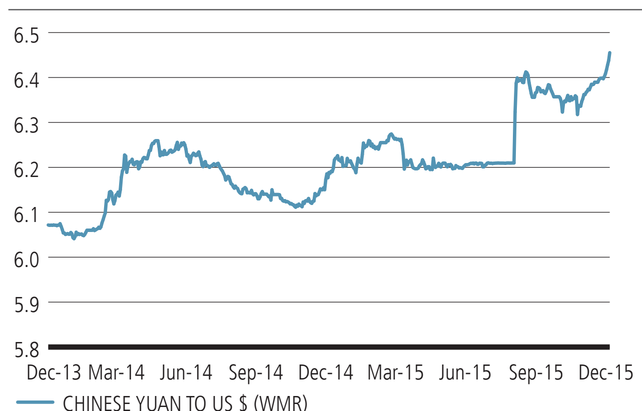


For illustrative purposes only. Data as of 30 November 2015 with a 12- to 18-month time horizon, based on information available to us. Views are not necessarily reflective of actual GIS portfolio positioning and are subject to change. UBS Asset Management's GIS Asset Allocation and Currency team.

Asset allocation

The current investment landscape is one in which nothing should be taken for granted. Each individual economic data release is heavily scrutinized while the frequent utterances of monetary authorities are subject to similarly detailed analysis. While these factors certainly drive asset prices, they do not always do so in a very predictable way. A 24-hour news cycle and instant communication technologies effectively encourage reactions to individual data points and a culture of short-termism. Such an approach increases the tendency of investors to miss the bigger picture. And for long-term investors, it is the bigger picture that should matter the most.

Chart 5: Chinese renminbi to US dollar December 2013 to December 2015



Source: Datastream, WM/Reuters, 14 December 2015

China in transition

In 2015, signs that China—the world's biggest economy in purchasing power parity terms, and second only to the US in terms of nominal GDP—could be slowing faster than anticipated caused investors heightened concern. This weighed further on the prospects of heavily resource-dependent economies such as Brazil and Russia, which have already suffered significantly as a result of China's transition from a manufacturing- to a consumption-led economic growth model. Brazil and Russia face structural and political obstacles, with ongoing oil price weakness posing a further headwind.

Establishing closer interlinkages with the global economy and financial markets is likely to bode well for China's prospects over the longer term.

China, however, does not necessarily face such easily identifiable headwinds. A subdued global growth backdrop is likely to lead to more muted demand for China's exports, but a resurgence in domestic consumption may go some way towards offsetting the negative economic impact of this. While the effectiveness of Chinese authorities' efforts to boost the economy via monetary and fiscal measures has to date been questionable, there is the potential for more action in 2016.

The surprise steps taken by the People's Bank of China to devalue the renminbi in August, and the decision by the International Monetary Fund (IMF) to include the currency in its special drawing rights basket, are indicative of progress in China becoming a more fully fledged actor on the global stage. It is the world's third-largest exporter (in the past five years), the renminbi is deemed by the IMF to be freely usable, and foreign investors are now regarded as having sufficient access to onshore markets.

- **Multi-asset investment insight**
  In the equity relative component of many of our portfolios, we have been expressing a preference for North Asia (Korea, Taiwan and China) over the broader MSCI Emerging Markets Index. We expect both the Korean and the Taiwanese economies to benefit from healthy global demand for the technology products and intermediary goods that they manufacture. Although the speed of the economic recovery in North Asia has been moderate in an absolute sense, it is significantly better relative to emerging markets overall. While from a valuation perspective emerging market equities appear attractive, we are not yet prepared to add directional exposure, although conditions could become more conducive to doing so in 2016.

High hopes for the Eurozone, some concerns about Japan

The Eurozone and Japanese equity markets have seen relatively strong performance in local currency terms this year, not least compared with US and UK equities. Riskier assets in both the Eurozone and Japan have been supported by fairly similar sets of conditions—continued monetary policy easing, currency weakness providing a boost to exporters, as well as a low oil price leaving consumers with more disposable income. The prospects for corporate earnings growth have been broadly favorable for both, too.

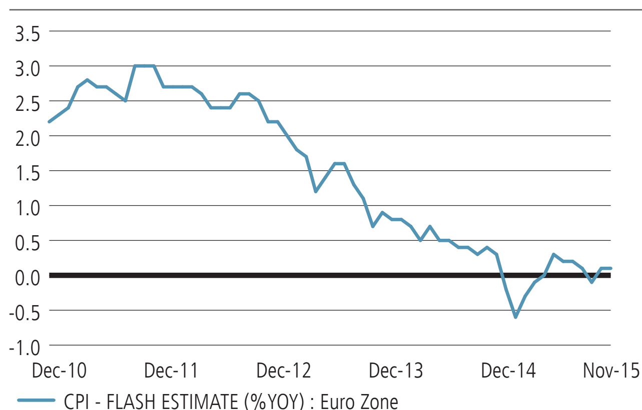
Eurozone economic growth in the coming quarters could surprise on the upside, while Japan's growth prospects look likely to remain broadly stagnant.

On the economic front, however, there are tentative signs of divergence. Eurozone economic growth in the coming quarters could surprise on the upside, while Japan's growth prospects look likely to remain broadly stagnant or even mildly recessionary. While there has been no marked change in the fortunes of either economy, investor sentiment on the Eurozone is likely to have taken a turn for the better due to clearer signs of improvement from a relatively low base.

In terms of its economic recovery and stage of business cycle, the Eurozone is far behind the UK and the US. While growth has remained relatively muted this year, the promising trend of clearer convergence in economic conditions between the peripheral and the core Eurozone countries has become more entrenched. The influx of migrants to the currency bloc—while bringing with it risks—also has the potential to boost GDP, if new workers can be successfully integrated into the Eurozone labor force. On the earnings front, while Japanese companies have been generating strong earnings on a sustained basis, Eurozone earnings growth is only now gathering pace.

The short-termism of some investors may make them forget that the European Central Bank (ECB) only expanded its asset-purchase program to include public sector securities in March 2015—at a time when even the concept of the ECB buying the bonds issued by Eurozone governments was still regarded as impossible by many. While the ECB's asset purchases have kept Eurozone inflation mostly out of negative territory, they have not yet had the effect of exerting sustained upward pressure on consumer prices. It remains to be seen whether the enhanced easing measures announced by ECB President Mario Draghi in December, and the prospect of further accommodation next year, provide the intended boost to regional growth and inflation.

Chart 6: Eurozone CPI inflation year on year annualized (flash estimate) December 2010 to November 2015



Source: ThomsonReuters Datastream, Eurostat, 14 December 2015.

- **Multi-asset investment insight**
  As in previous quarters, our preference is for developed equity markets outside of the US. We have become slightly less positive on Japanese equities, given the lack of a clear catalyst at this point to drive growth and inflation higher. Nevertheless, we remain overweight, primarily due to the strong earnings growth still being delivered by Japanese companies which is lending support to valuations.
  Our outlook for Eurozone equities is positive. We have benefited from some European equity relative value trades, such as a long German DAX vs. short Swedish OMX position. German exporters have been among the biggest beneficiaries of continued euro weakness

Relative US economic strength paves the way for rate normalization

The Fed finally raised interest rates for the first time in around nine years in December. The market widely expected the increase, so the focus was on the language of the announcement and the projections for future rate increases. Both of these were marginally more dovish than expected, with the Fed now using the term "gradual" to describe the likely path of monetary policy. It's also notable that Fed forecasts for growth and inflation did not come down markedly from previous forecasts, contrary to lower expectations issued recently by some market participants. In part, that reflects the Fed's confidence in

the US economy, and its belief that the global concerns it articulated in September (i.e. China) have lessened.

Over the longer term, as equally important as the first rate hike is the pace of further increases and their magnitude, as well as the length of the tightening cycle. Tighter US monetary policy, in our view, is a positive move as it signals the Fed's confidence in the domestic economic recovery. We will be closely monitoring its impact on US consumer price inflation, which remains below the Fed's 2% target, but could trend upwards in 2016. The effects of Fed tightening will also reverberate through the global economy and financial markets. Emerging market economies, particularly those with US dollar (USD)-denominated debt loads are likely to suffer as their currencies depreciate against a strengthening USD.

However, with the downside risk of policy error having been mitigated by the clarity of the Fed's December announcement, the case for investing in select emerging market equity and debt securities that are trading at attractive valuations is growing.

Tighter US monetary policy signals the Fed's confidence in the domestic economic recovery.

- **Multi-asset investment insight**
  Following the Fed, the Bank of England (BoE) looks like it could be the second developed central bank to begin raising interest rates. UK GDP growth trends have been fairly positive, the unemployment rate is trending downwards and, so far, there appears to have been limited impact on investor sentiment of the country's efforts to renegotiate the terms of its EU membership. Markets, however, are not expecting the Bank of England to raise its benchmark interest rate until the latter half of next year. This is being reflected in low UK Gilt yields relative to US Treasuries—we believe that this spread is too wide. Our view is that the BoE is likely to raise rates sooner than markets are expecting, and are therefore long Treasuries vs. short Gilts.

Currencies

After the Fed refrained from raising rates in September to the surprise of many, consensus expectations converged on a December rate hike. This meant that the US dollar (USD) remained in a strengthening environment against most other currencies for much of the fourth quarter. However, when the ECB failed to enhance its quantitative easing program in early December to the extent that had been priced in by markets, developed currencies including the euro, the yen and the franc surged against the USD. Following the third quarter's sharp losses, many emerging market currencies recovered some ground against the USD early in the quarter but were under pressure again into the end of the year.

- **Multi-asset investment insight**
  Across our portfolios, we retain our conviction in the long Japanese yen position, which we have paired with short positions in the euro and the USD. Real exchange rate levels signal that the yen is the most undervalued developed market currency. While both the ECB and the BoJ continue to pursue very loose monetary policy, in our view, further easing is more likely on the part of the ECB—as seen in December. The BoJ has refrained from adding to its quantitative and qualitative easing, against the expectations of many. Our long yen, short USD position meanwhile tends to act as a diversifier in risk-off environments, which is a key reason for holding it in our portfolios.

  Elsewhere, our long USD vs. New Zealand (NZD) dollar position has continued to contribute positively to performance. US economic strength and tighter monetary policy remains supportive of the USD, while our investment thesis that the Reserve Bank of New Zealand has the potential to cut rates further if growth disappoints. The vulnerability of New Zealand's economy to China's growth slowdown and sluggish consumer confidence at the domestic level are both factors that are likely to weigh on the NZD.

Alternatives

Global oil prices fell to levels last seen at the height of the financial crisis during December. Supply issues were the major driver of the declines, with the lack of agreement between members of the Organization of the Petroleum Exporting Countries (OPEC) sending the price of Brent Crude below USD 40 per barrel. For the first time in two decades, OPEC failed to mention any quota or production target in its update to markets. Without a target, major producers will continue to pump more oil. Elsewhere, the strong US dollar continues to negatively affect emerging market energy demand.

Over the medium term, our view remains that a more coherent OPEC strategy leading to production cuts will emerge in 2016 to support global oil prices.

Meanwhile, the strong US dollar and concerns about Chinese demand have been the major contributors to recent weakness in copper, nickel, zinc and iron ore. Most metals now trade close to or below the marginal cost of production. With supply cuts already coming in nickel and zinc as the major mining companies cut back on higher cost operations, we expect more positive market forces prevailing into 2016.

Real estate

While financial markets were much calmer in October and November compared to the preceding three months of 3Q15, real estate investors remain concerned about the near-term global economic outlook. The UBS Global Surprise Index* has trended lower in recent months suggesting that global growth may be falling short of expectations.

Chart 7: UBS Global Growth Surprise Index

Source: UBS Asset Management, Global Real Estate Research & Strategy, 14 December 2015

While many emerging market economies and asset classes have struggled in recent quarters—with this trend likely to continue given the prospect of accelerating outflows—the US and European economies should prove relatively resilient. An inventory swing could hit US growth during the next quarter, but the economy's fundamentals look sound, and its trade and financial market exposures to the emerging economies look manageable.

Real estate continues to provide attractive opportunities for investors

Against this uncertain global growth backdrop, we remain fairly optimistic about near-term prospects for real estate, particularly for good quality real estate.

Coupled with relatively muted levels of construction, with the exception of some outliers, even modest levels of growth in the demand for space are translating to gains in income. These gains are coming in the form of higher rents, less empty space, and/or a reduction in the incentives a landlord needs to offer, such as rent-free periods or a contribution to renovation or moving costs. In fact, gains in capital value are giving way to income growth as the primary source of returns. There are exceptions, but with transaction volumes falling back and pricing already stretched, there is little room left for further major increases in prices. As interest rates rise and risk premiums widen, some markets could potentially see a dip in transacted sales prices that will only partially be offset by higher income. US interest rates, however, are likely to rise very slowly. In a low interest rate/low inflation/low yield world, property is a relatively attractive asset class that should continue to attract inflows.

A changing investment landscape

In the past, the expectation of central bank easing and a low rate environment provided a degree of reassurance for real estate investors and financial markets. Now, however, the Fed has raised rates for the first time in around nine years. In other developed economies, policymakers have less ammunition to cut interest rates, with many already at the zero lower bound, or below.

But zero interest rates do not necessarily mean policymakers have run out of options. In fact, central banks could delay planned rate rises, cut rates or taken them further into negative territory, reintroduce or enhance existing quantitative easing (QE) programs, or introduce new forward guidance and commit to keeping interest rates low for an even longer period. This would perpetuate the low yield context we have described, and continue to draw capital towards real estate which offers a more attractive yield.

A resilient quarter for real estate markets

In the commercial real estate market, despite the significant increase in financial market volatility in the second half of the year, preliminary data suggests that core investment performance remained resilient, with attractive returns in both the US and the UK markets.

Looking ahead, in an environment of moderate global growth where interest rate hikes are being pushed back, the near-term outlook for core real estate continues to look healthy, particularly relative to the volatility of some of the listed asset classes.

UBS Global Growth Surprise Index
An understanding of where economic data is headed is critical to investment decisions. The propensity for data to surprise consensus forecasts, either on the upside or the downside, is revealing, both for its impact on asset prices and the way it can affect investor judgement. The UBS Global Growth Surprise Index is designed to capture the degree to which incoming economic data meets forecasts. Down- and upward trends in the index offer insights into the workings of the global economy and the business cycle.

The index is calculated as a GDP-weighted average of country-specific data surprise indices from both developed and emerging market economies. These are in turn calculated using data on out-turns and consensus forecasts from Bloomberg. When the out-turn of a data release exceeds the published consensus, the surprise index moves up by one point. When it falls short of the published Bloomberg consensus, the index moves down by one point.

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