April 2015
Asset management research

Global Asset Views

Economic and market developments in perspective

Formulating our global asset views

Assessing the economic and market environment is a key part of UBS Global Asset Management's investment strategy-setting process across all investment areas. Our Cyclical Market Forum, open to representatives of all investment teams, regularly debates important economic and market themes and their potential impact on our investment strategies. The Forum's purpose is to examine the main economic and market drivers – typically through scenario analysis over a 12- to 18-month time horizon – and to foster debate between the teams managing different asset classes.

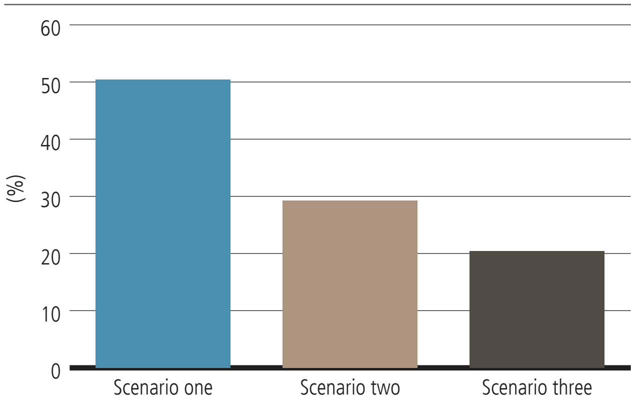
The way in which the output from the Forum is used varies across UBS Global Asset Management's investment teams, and it is just one of a number of inputs into each team's investment process. One of the key benefits of the Cyclical Market Forum is the opportunity to exchange research and viewpoints from the various investment specialists and to examine the intersection between top-down and bottom-up drivers. As such, it broadens the input into our strategy-setting process in a structured format. The latest meeting of the Forum took place in March 2015 and the debate was intense and wide-ranging. The focus was on three potential economic scenarios, which can be broadly characterized:

Scenario 1: The on going
Scenario 2: The up rise
Scenario 3: The downfall

All Forum participants voted on the probability of each scenario. The result was a wide dispersion of views across all three scenarios, but the preferred choice was Scenario 1 (see Figure 1).

In this publication, we expand on the scenarios and their potential impact on all asset classes. We also provide our outlook for our asset allocation and currency strategies.

Figure 1: Average probability vote



Source: UBS Global Asset Management

Curt Custard
Head of Global Investment Solutions
Chair of the Cyclical Market Forum
UBS Global Asset Management

April 2015

Scenario 1

The on going

Participants of the Cyclical Market Forum voted Scenario 1, which is aligned with industry consensus, as the most probable scenario (see figure 1, page 1). The consensus scenario sees reasonable growth in North America and Asia, gradual improvement in EMEA and more subdued progress in South America. Inflation is a limited concern apart from some emerging markets, such as in South America where it is too high. Compared to the previous quarter, the consensus scenario has a more positive growth outlook for the Eurozone, where aggressive monetary policy is expected to start having positive effects on the real side of the economy, also thanks to a materially weaker currency.

Oil market dynamics are central to this scenario. Lower prices help energy importers and should therefore facilitate growth in the Eurozone and Asian economies, such as Japan and China. Energy exporters across the globe will suffer. An expected equilibrium oil price of oil of USD 65 per barrel would be devastating for countries like Russia and Venezuela, which need much higher prices to finance large government budgets.

United States

The US continues to be in good shape, registering solid job growth together with strong demand for housing and goods. The most widely tracked variable is new orders for capital expenditure, which may be impacted by lower oil prices. This would diminish growth expectations and could therefore potentially delay the Federal Reserve's (Fed) rate increases that are currently projected to begin in the summer.

Eurozone

Eurozone growth is spurred by higher exports, thanks to a weaker euro, lower energy import costs and ultra-loose monetary policy. Inflation falls into negative territory only temporarily and remains well below target until the end of 2016.

Japan

Japan's consumption tax hike in 2014 continues to have negative repercussions on aggregate demand. Wages have started increasing gradually, which might help reverse the effect of the taxes, but GDP growth remains subdued throughout 2016.

Emerging markets

Emerging markets remain bifurcated. Countries importing energy and countries with positive net exports stand to gain while countries with twin-deficits (both government and trade) stand to lag. Furthermore, the latter countries are expected to experience volatility when the Fed starts raising rates. China is clearly in recovery and growth, while subdued, is expected to keep improving. On the other hand, Russia continues to suffer from both the European economic sanctions and lower energy prices. Similarly, Turkey continues to fight inflation and political turmoil. The outlook for Brazil has deteriorated with legal risks for the president. Brazil's fiscal policy is still out of control with fiscal and external imbalances threatening economic growth, exchange rate stability and anti-inflationary policies. Conversely, we expect India to keep moving in the right direction thanks to reforms, such as the reduction of fuel subsidies. However, much more is needed to transform this bureaucratic and legal quagmire into a fertile land for entrepreneurs. Inflation remains relatively high but close to its central bank target.

Figure 2: Probability of Scenario 1

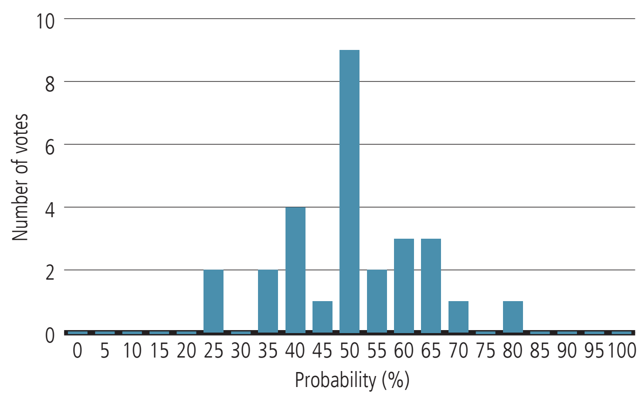


Figure 3: Scenario 1

	GDP growth (%)			CPI Inflation (%)		
	2014	**2015**	**2016**	**2014**	**2015**	**2016**
Major 4 (M4)	**1 ½**	**2 ¼**	**2 ¼**	**1 ½**	**¼**	**1 ¾**
US	2 ½	3	2 ¾	1 ¾	½	2 ¼
Eurozone	1	1 ¾	1 ¾	½	-0.25	1 ¼
Japan	0	¾	1 ½	2 ¾	1	1 ¼
UK	2 ½	2 ½	2 ¼	1 ½	½	1 ¾
BRICs	**5 ¼**	**4 ½**	**5 ½**	**4**	**4 ½**	**3 ¾**
China	7 ½	7	7	2	1 ½	2 ¼
Russia	½	-4 ¼	½	7 ¾	15	7
Brazil	0	-0.25	1 ½	6 ¼	7 ¼	5 ½
India	7 ½	7 ¾	7 ¾	6 ½	5 ½	5 ¾
M4 + BRICs	**2 ½**	**2 ¾**	**3**	**2**	**1 ½**	**2 ¼**

Source: UBS Global Asset Management
Projections based on UBS Global Asset Management

Figure 4: GDP growth in Scenario 1

GDP growth quarter-on-quarter at an annualized rate

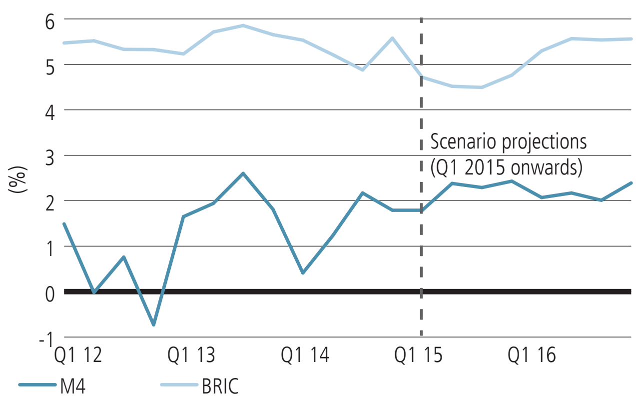
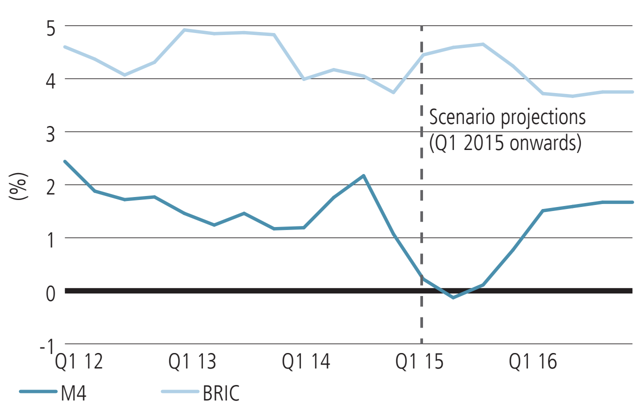


Figure 5: CPI inflation in Scenario 1

Headline CPI inflation year-on-year, quarterly



Source: Bloomberg Finance L.P., IMF, UBS Global Asset Management
Projections based on UBS Global Asset Management

Scenario 2

The up rise

Scenario 2, the bullish outlook with economies facing a range of potential upsides relative to Scenario 1, was voted the second most likely (see figure 1, page 1). Proponents expressed a positive bias towards the possibility of GDP growth surprise, particularly from Japan, India and the Eurozone. In this scenario, lower oil prices have a generalized positive effect on global consumption with second round effects on other sectors. In addition, the latest round of monetary policy easing around the world is likely to facilitate acceleration in global investment spending.

United States

Faster business investment and stronger housing activity accelerates recovery in the US. Labor market participation bounces back and this results in positive ramifications for the economy - higher growth with low inflation. Consumption picks up further on the back of faster wage growth and lower oil prices.

Eurozone

A weaker euro, lower energy prices and stronger external demand work in concert to facilitate economic growth. Low borrowing costs and ample availability of liquidity incentivize borrowing and investment spending. Moreover, there is faster progress in structural reforms, infrastructure expenditure and the banking union.

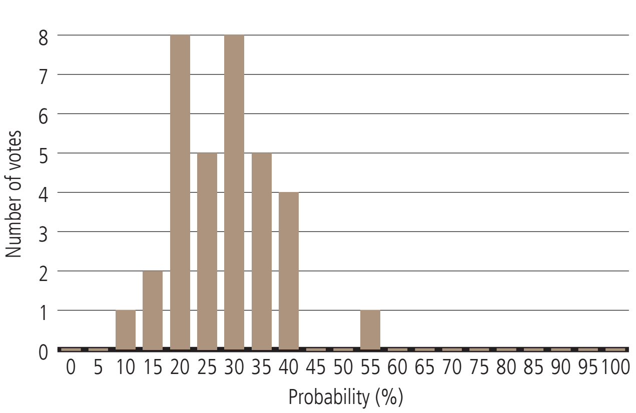
Japan

The pick-up in structural reforms in Japan leads to faster economic growth. Higher wages facilitate stronger domestic demand. Lastly, a weaker currency supports stronger exports.

Emerging markets

Stronger growth in the west helps support Chinese exports while the economy rebalances, resulting in a slower deceleration of activity. Likewise, more accommodative global monetary policy helps stabilize the shadow banking sector allowing the Chinese government to provide additional stimulus. Brazil benefits from stronger global demand for commodities on the back of a more robust global recovery.

Figure 6: Probability of Scenario 2



Source: UBS Global Asset Management

Reduced political tensions and progressive increases in oil prices, together with a stronger global recovery allow the Russian government to introduce fiscal stimulus to offset the effect of sanctions. In addition to reforms adding to economic growth, India benefits from the positive effect lower oil prices have on its budget, current account balance and inflation.

Figure 7: Scenario 2

	GDP growth (%)			CPI Inflation (%)		
	2014	**2015**	**2016**	**2014**	**2015**	**2016**
Major 4 (M4)	**1 ½**	**2 ¾**	**3 ¾**	**1 ½**	**2**	**2 ¾**
US	2 ½	3 ¾	4	1 ¾	2	3
Eurozone	1	2 ¼	3 ¼	½	2	2 ¼
Japan	0	1 ¾	3 ½	2 ¾	1 ½	2 ¼
UK	2 ½	3 ½	4	1 ½	4	4
BRICs	**5 ¼**	**7 ¼**	**7 ¾**	**4**	**6 ¼**	**6**
China	7 ½	8 ¾	8 ¾	2	3 ½	4 ½
Russia	½	2	4 ¾	7 ¾	18	11 ¼
Brazil	0	3	4 ¼	6 ¼	6 ½	5
India	7 ½	9 ½	9 ½	6 ½	8 ½	9 ¼
M4 + BRICs	**2 ½**	**4**	**4 ¾**	**2**	**3 ¼**	**3 ¾**

Figure 8: GDP growth in Scenario 2

GDP growth quarter-on-quarter at an annualized rate

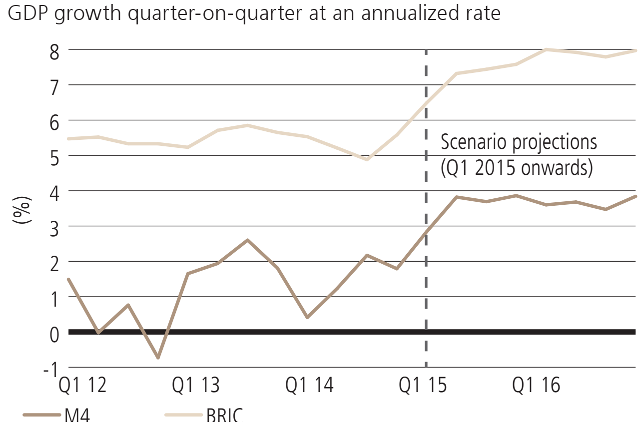
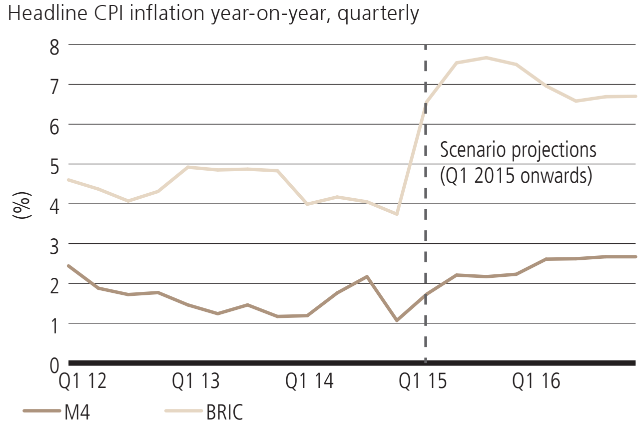


Figure 9: CPI inflation in Scenario 2

Headline CPI inflation year-on-year, quarterly



Source: Bloomberg Finance L.P., IMF, UBS Global Asset Management
Projections based on UBS Global Asset Management

Scenario 3

The downfall

Scenario 3, the bearish outlook relative to scenario 1, was voted the least probable (see figure 1, page 1). Proponents expressed concerns regarding global inflation expectations as well as growth expectations in Brazil, China and especially Russia were this situation to arise. In this scenario, a substantial cut in oil supply, caused by an OPEC production cut or terrorist attack, pushes oil price back to USD 100 a barrel. In addition, there is a spike in financial market volatility as the Fed starts hiking rates. This rate hike leads to turbulence in the emerging markets, similar to when the Fed announced tapering of quantitative easing (QE).

United States

Lower trend growth proves to be structural, and not cyclical, due to technology and demographics. Markets could overreact to the Fed's tightening, thereby hampering the recovery. Political uncertainty and concerns surrounding the ‚debt ceiling' would affect business confidence and investment. Lastly, a decreased level of energy exploration, triggered by low energy prices, puts a brake on corporate capital expenditure.

Eurozone

The Eurozone faces political fragility and uncertainty stemming from the Ukraine crisis, the risk of ‚Grexit' and political elections in Spain. It might experience a ‚creditless recovery' whereby regulatory limits and the lack of a developed credit market prevents the European Central Bank's (ECB) quantitative easing program from materializing into stronger lending.

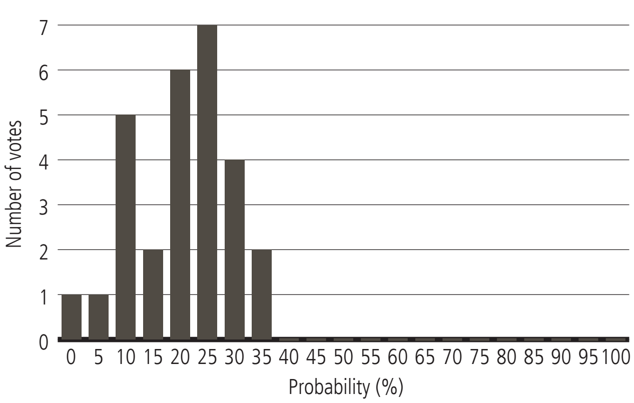
Japan

In Japan, Abe's 'third arrow' of reforms never gets deployed. Higher inflation depresses consumer spending and, consequently, business confidence. Moreover, higher utility bills squeeze corporate profit margins and investment spending.

Emerging markets

Non-performing loans soar in China leading to intense market fears of a financial burst and liquidity crunch. The partial peg to the US dollar could lead to a strong appreciation of the Chinese renminbi relative to other currencies and could harm the export sector. In Brazil, twin deficit and inflation make the country extremely vulnerable to further capital outflows. Lower oil prices and further sanctions lead to a severe strain on the Russian banking sector and keep Russia in a prolonged recession. India experiences faster tightening of credit conditions in the face of quicker US rate hikes.

Figure 10: Probability of Scenario 3



Source: UBS Global Asset Management

Figure 11: Scenario 3

	GDP growth (%)			CPI Inflation (%)		
	2014	**2015**	**2016**	**2014**	**2015**	**2016**
Major 4 (M4)	**1 ½**	**1 1/4**	**½**	**1 ½**	**-0.5**	**¼**
US	2 ½	2 ¼	1 ½	1 ¾	-0.5	¾
Eurozone	1	¼	-0.25	½	-1	0
Japan	0	-0.5	-0.5	2 ¾	0	-0.25
UK	2 ½	1 ½	½	1 ½	-0.25	¾
BRICs	**5 ¼**	**3**	**3 ¾**	**4**	**2 ¾**	**2**
China	7 ½	6 ¼	6	2	¼	¼
Russia	½	-8	-4 ½	7 ¾	11 ¾	5 ¼
Brazil	0	-2	-1	6 ¼	5 ¾	4 ½
India	7 ½	5 ½	5 ½	6 ½	4 ¼	4
M4 + BRICs	**2 ½**	**1 ¾**	**1 ½**	**2**	**¼**	**¾**

Figure 12: GDP growth in Scenario 3

GDP growth quarter-on-quarter at an annualized rate

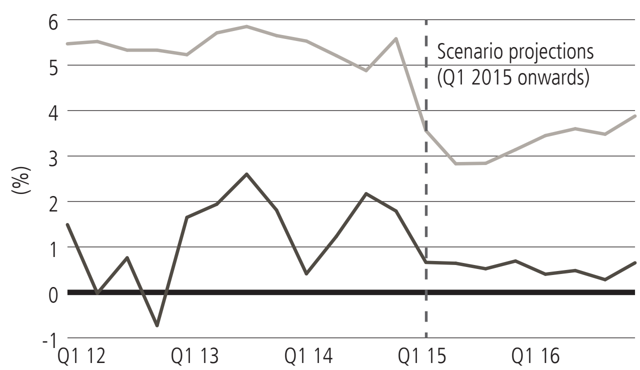
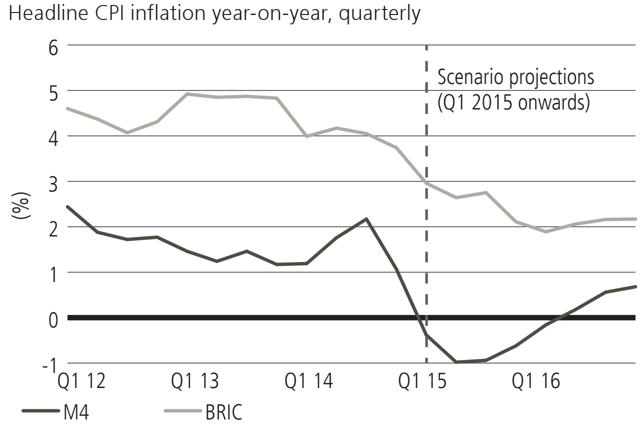


Figure 13: CPI inflation in Scenario 3

Headline CPI inflation year-on-year, quarterly



Source: Bloomberg Finance L.P., IMF, UBS Global Asset Management
Projections based on UBS Global Asset Management

Asset Allocation

Flashback

Financial markets are one of the best documented and studied subjects with every event and milestone covered by analysts and journalists worldwide. Having this vast pool of financial literature facilitates our natural instinct to refer to the past to help picture different scenarios for every 'what if' question pertaining to the present and future. Policymakers turn to the past to see what worked and what did not. Portfolio managers look at past asset class interaction and market reactions to help better position going forward. Traders analyze past security prices to gauge momentum for the near future. The list is endless. Yet, the most commonly used phrase in the finance industry is "past performance is not an indication of future results." This begs the question – to what extent can we use past events as groundwork for the future?

The Fed's tightening plan triggers a flashback of the 2013 'taper tantrum' when the announcement of winding down US quantitative easing led to a surge in global financial markets, especially in the emerging markets. This forces us to question - will the Fed be responsible for the sequel of the 'taper tantrum'? And if so, would the 'fragile five' – Brazil, India, Indonesia, Turkey and South Africa – be cast to play the same role again or have they taken action since June 2013 to withstand such shocks going forward? Macroeconomic fundamentals played a vital role in determining a country's ability to withstand the sudden wave of sell-offs. Countries facing twin deficits (government deficit and current account deficit), high inflation, and weak growth prospects were the most vulnerable and hence, the 'fragile five' experienced the brunt of this in 2013.

This time around, we have to be mindful of the fact that the macro environment has changed. Central banks, especially in developed countries are longer synchronised in their policy stances. While the Fed is signalling monetary tightening, Bank of Japan continues to engage in QE, while the European Central Bank just began its QE program. Indeed 24 central banks have already cut rates this year and it will not be surprising if more central banks follow course. In this environment of continued global liquidity, it's not immediately clear whether the Fed's tightening will have a similar impact to when it announced tapering QE in 2013. In addition, the 'fragile five' are armored differently this time. India and Indonesia have undertaken several reforms which have increased their confidence and growth prospects, making them better equipped and less vulnerable. However, Turkey, Brazil and South Africa are still facing challenges related to inflation, government deficits and political uncertainty, which makes these countries more vulnerable.

With several elections just around the corner, politics is another aspect that makes us turn to the past for reference. It compels us to reflect on past political events in deciding who to vote for this time around. Following Syriza's win in Greece, non-traditional anti-austerity parties are making headlines in Europe and pose a serious threat to the more established parties in this year's elections in Europe. Many link Spain's Podemos and Ireland's Sinn Féin as Syriza counterparts – indeed Podemos Secretary General, Pablo Iglesias, has taken every opportunity to identify Syriza's win as the first step of an anti-austerity movement that will sweep across Europe. Whether this turns out to be the case will hinge on the outcome of Syriza's negotiations on reform and re-paying Greece's creditors.

Similarly, oil markets have been at the forefront of investors' minds since mid-2014 begging the question - will oil prices revert to previous, higher levels? After a rigorous debate surrounding this question at our theme-specific Cyclical Market Forum, we expect markets to stabilise around USD 65 per barrel in the short-term. This decline in oil prices has led to a redistribution of wealth between oil producer nations and consumer-driven economies. With lower oil prices acting akin to a tax cut for individuals in these nations, which in turn could spur on consumption and consumer confidence. For an in-depth review of our views on oil, please refer to *Global Asset Views Thematic Edition – Oil Market Dynamics*.

Our Strategies: Equity

Given the environment of accommodative monetary policy and lower oil prices, we expect aggregate demand to pick up resulting in more robust global growth. As such, we currently prefer global equities to fixed income. We maintain our bias towards the European and Japanese equity markets. These consumer-driven, energy-importing economies stand to benefit from lower oil and are relatively attractively valued in our view with strong momentum and continued policy support. We have replaced our overweight position in the MSCI World Index with the MSCI EAFE Index, which is made up of developed markets outside North America, encompassing Europe, Australasia and the Far East. While the US economy continues to have a favorable growth outlook, we see this as largely priced in to equity markets; there is more scope for surprise to the upside from EAFE, particularly the Eurozone. On the other hand, a strong USD, potential wage cost pressure, and the Fed's upcoming rate hike seems to weigh on the US equity market. We continue to favor North Asian emerging markets relative to the broader emerging market spectrum. North Asian equities include a number of energy importers who stand to benefit from lower oil at the expense of a number of oil exporter nations, represented by the broader emerging market index. A number of idiosyncratic challenges exist for countries such as Brazil (structural issues) and Russia (sanctions) that are likely to hinder the performance of broader emerging markets going forward.

Our Strategies: Fixed Income

We believe that muted growth, moderate inflation and continued central bank easing in many of the world's largest economies is likely to result in bond yields remaining contained in a fairly narrow range. As a result, we are tending to trade duration on a tactical basis and through the use of curve trades.

This backdrop has resulted in many sovereign bonds, particularly in Europe, trading at negative yields. Consequently, we see investors getting pushed into investment grade corporate bonds to achieve some yield and have positioned our portfolios to capitalize on this dynamic.

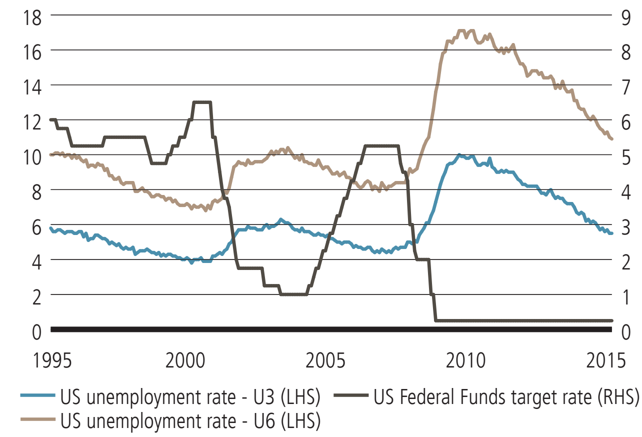
Emerging market debt yields are comparatively attractive in our view but, to some extent, reflect investor nervousness around the likely impending tightening of monetary conditions in the US and the fallout from the collapse in oil prices. Nevertheless, we see value in holding exposures to this asset class (with an Asian tilt) versus Japanese government bonds, where the central bank remains committed to increasing inflation and the labor market remains relatively tight.

We have become slightly more constructive on the high yield debt market, as we believe investors are being more appropriately compensated for the liquidity risk inherent within the asset class. Furthermore, we believe that the default rate outlook is comparatively benign and continue to see strong demand for income-producing asset classes. That said, some caution is warranted as the market continues to digest the ongoing impact of weaker oil prices and its impact on issuers in the US energy sector.

Our Strategies: Alternatives

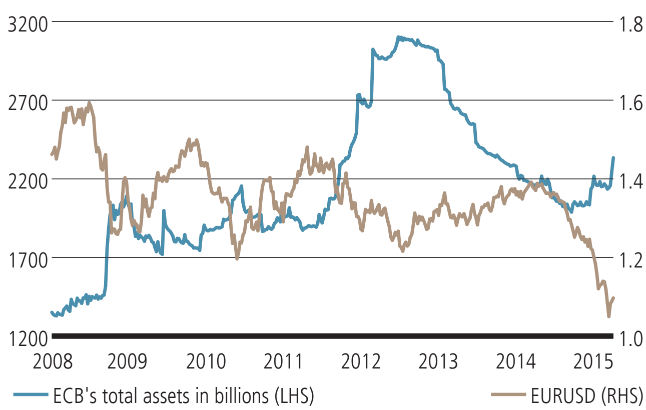
Commodities remained challenged in the near term by a strong US dollar, slowing emerging market growth and ample supply. However, many commodities are trading at or below their current cost of production. This, along with supply cuts and a more positive global growth picture can create a better environment for commodities over the medium term. Even though catastrophe risk insurance premiums have reduced due to a low number of events, we continue to hold this exposure for diversification benefits. We believe infrastructure continues to look favorable as a long-term investment delivering stable cash flows, while also offering diversification benefits to a portfolio.

Figure 14: Federal Funds rate against US unemployment data



Source: Datastream
Data as of 31 March 2015
U3 is the official unemployment rate
U6 also accounts those marginally attached to the labor force, plus those employed part time for economic reasons.

Figure 15: European Central Bank's total assets against EURUSD



Source: Bloomberg Finance L.P.
Data as of 31 March 2015

Currency

Central bank dominance

Central bank action has always directed markets but since the great financial crisis, it seems to be dictating markets. This has led markets to labor every word of central bankers in an effort to get a better understanding of their next step. While the European Central Bank captured the limelight when it surprised markets by announcing a larger than expected quantitative easing policy, markets remain focused on the US Federal Reserve as it moves towards its first rate hike since 2006.

Towards the end of the quarter, an ever-increasing focus was placed on the use of language within the Fed's statements, in particular, the removal of the word 'patient' with respect to when it would embark on its interest rate hiking cycle. In the event, the word was removed from the statement but it was noted that the Federal Open Market Committee's (FOMC) decision would be data-dependent.

In addition, FOMC projections hinted at a slower path of hiking with a lower order of magnitude than previously indicated. In short, there was something for the bulls and the bears. The US dollar, which had been in the ascendancy, temporarily had the wind taken from its sails. While we believe the US dollar is no longer as attractively priced relative to a broad index of currencies, strong US economic data and the expected Fed policy normalization remain supportive.

In Europe, the Swiss National Bank (SNB) surprised markets by dropping its commitment to cap the Swiss franc against the euro, throwing markets into a state of flux with heightened volatility and a sharp appreciation in the Swiss franc. Soon after, the European Central Bank surprised markets by committing to a quantitative easing program that will exceed 1 trillion euros to fight the threat of deflation, which added to downward pressure on the euro. For example, the euro has fallen 10% against the US dollar since the start of the year. This depreciation should have a meaningful impact on corporate earnings and exports, facilitating growth in the Eurozone.

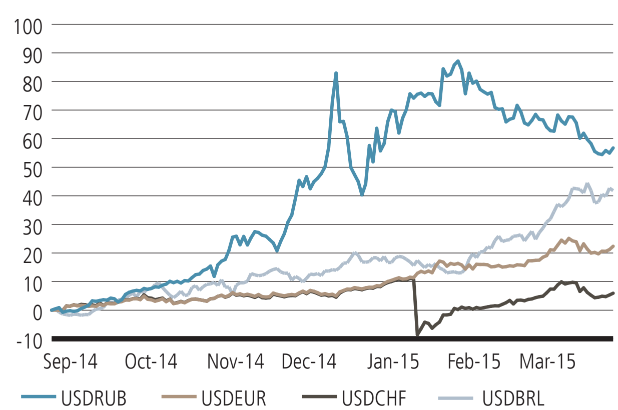
Within emerging markets, all eyes are on Brazil as high inflation, poor growth prospects and political instability has led to a 20% depreciation of the Brazilian real against the USD this year, its lowest level for a decade. Even though the central bank has been hiking rates to control inflation, its efforts have been ineffective. Furthermore, a colossal corruption scandal has prompted Brazilians into considering an impeachment of the President and credit rating agencies into deliberating a possible downgrade.

Our Strategies

The US dollar continues to remain our largest overweight position; however, the risk may be that it is over-owned in the market. Given Mexico's close link to the US and its relative competitiveness as a manufacturing location outside of Asia, the prospects for growth surprises seem favorable and thus, we continue our bullish conviction on the Mexican peso. We are moderately overweight the Indian rupee due to the country's reform agenda, both in terms of growth prospects and fiscal consolidation. The economic fundamentals have already improved and it is now much less vulnerable and it is debatable whether it remains as fragile as the other 'fragile five'.

We continue to hold an underweight exposure to developed market currencies that are dependent on commodity prices, such as the New Zealand dollar, which we believe is largely overvalued. In addition, New Zealand's economy is vulnerable to any global downturn due to its high level of external and private sector debt. Following the SNB's removal of the 1.20 EURCHF floor, we added to the underweight CHF position after concluding that the exchange rate had overshot resulting in a stronger valuation case for the position. Moreover, deterioration of the Swiss balance of payment surplus indicates that this CHF strength is unlikely to be sustainable, making the CHF our largest underweight position.

Figure 16: Major currency movements



Source: Bloomberg Finance L.P.
Data as of 31 March 2015
Rebased to 0 on 29 August 2014

Outcome-oriented solutions. Delivered.

UBS Global Asset Management's 32-year track record in multi-asset funds is one of the longest in the investment industry. And we have pioneered services that go beyond fund management by delivering outcome-oriented solutions to clients, whatever their needs.

Our Global Investment Solutions team boasts a diverse range of investment and risk management specialists based in seven different time zones. The team leverages UBS Global Asset Management's global resources while providing local expertise.

Clients have access to tailored investment advice and to a range of multi-asset funds catering to a wide range of needs. The offering continues to evolve with the ever-changing requirements of investors.

Whether an investor is seeking income in a low-yield environment, equity exposure with structured downside protection, or a comprehensive package to achieve a pension fund's goals, we can deliver a solution that fits your needs.

Product-driven solutions	Advice-driven solutions
• Global and regional balanced	• Pension risk management
• Diversified income	• Investment risk systems and advisory services
• Benchmark-agnostic	• Strategic portfolio advice
• Asset allocation and currency alpha	• CIO outsourcing
• Managed volatility portfolios	• Family office solutions
• Convertible bonds	

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Asset Allocation & Currency	A rich heritage of proven, team-based portfolio management and investment advisory capabilities including: • A long-standing, disciplined investment philosophy • A broad array of both traditional and innovative global multi-asset portfolios • Alternative sources of alpha and diversification including currency, convertible bonds and commodities, either on a stand-alone basis or as part of a multi-asset portfolio
Global Risk Solutions	Spanning all aspects of a sound risk management practice: • Consistent risk measurement across a broad range of traditional and alternative assets • Full operational support and oversight of risk management data and processing • A flexible advisory service run by experienced risk managers offering tactical and strategic insights to portfolio managers and boards
Structured Solutions	Globally focused capability targeting a diversified client base, providing: • Customized solutions typically employing derivatives or derivative techniques • Collaboration with clients to design precise outcomes such as downside risk control or targeted income • Particularly relevant for clients switching from benchmark-relative returns to a focus on outcomes
Manager Selection	We seek to give our clients exposure to the best specialist fund managers: • Research insights supported by qualitative and quantitative assessments and comprehensive due diligence • Knowledge of managers' skills and styles utilized to construct portfolios with diversified alpha sources • Ongoing and extensive review and adjustment of portfolios based on forecast risks and opportunities
Pension Risk Management	• Focus on maximizing the funding ratio return while minimizing its volatility • Implementation of capital efficient hedging strategies incorporating physicals and derivatives • Client-oriented team combining portfolio management, implementation, derivative and actuarial expertise

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