Global Perspectives

Overview

- **Equities:** We maintain a modest risk-on stance on equities but will remain tactical in our positioning, as we expect increased volatility. We are focusing our allocations on markets outside of North America.
- **Fixed Income:** We have moved to an underweight duration position and currently prefer corporate credit over sovereign debt. Central bank policy has created depressed yield curves with limited upside, making credit more attractive.
- **Currency:** We believe that we are still in a strong US dollar environment and continue to hold the currency as our largest overweight, as we continue to be short the New Zealand and Australian dollars.

The month in review: Decoupling continues

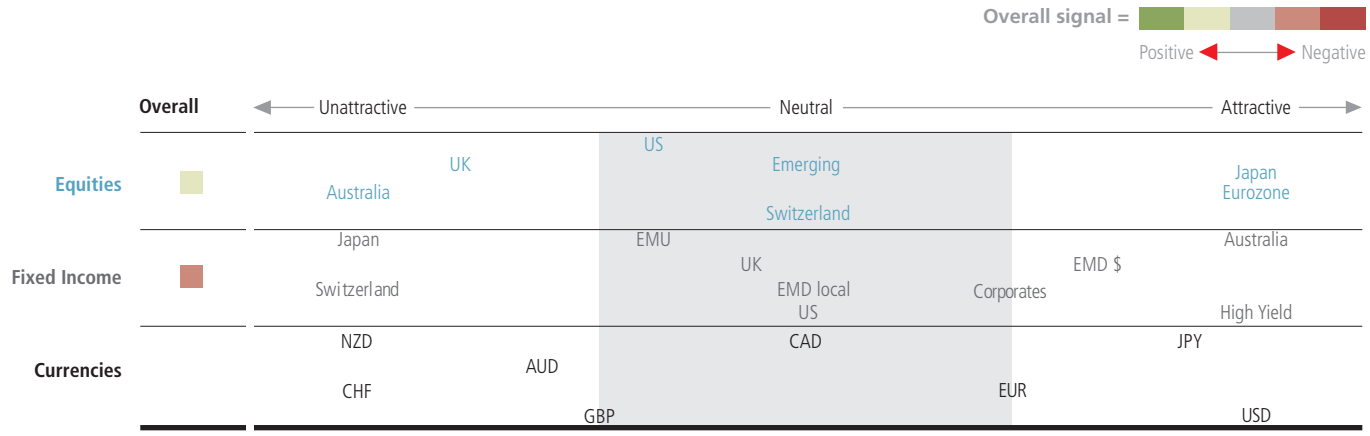
- Developed equity markets continued their grind upwards in May, with the MSCI World returning 0.4% for the month and up 5.33% for the year. Strong performance came from Japan at +5.0% (JPY) while emerging markets equities fell by 4.0% during the period.
- German bunds continued their selloff that began in mid-April, reaching a peak of 0.72% on the 10-year. US Treasuries also slid in May, with the 10-Year Treasury moving from 2.03% up to a peak of 2.29% in mid-May and ending the month at 2.12%.
- In the US, Q1 GDP was revised downwards to a -0.7% seasonally adjusted annualized rate from a previously reported 0.2% rate. Durable goods orders declined in April, but this was coupled with an upwards revision of the April figure to 5.1%, up from a previously reported 4.0%. Additionally, new home sales rose 6.8%, beating analyst estimates.
- Inflation in Germany increased to 0.7%, while Italian GDP grew 0.3% in Q1, its best performance in three years. China continues to deteriorate with the HSBC China Manufacturing PMI (purchasing managers' index) coming in at 49.2, a third straight month of contraction. India PMI rose to 52.6, and with a first quarter GDP of 7.5%, India represents the fastest growing economy in Asia.

Outlook: Caution needed

- While we believe we are in a positive environment for risk assets over the medium term, we anticipate that volatility over the next few months will remain at heightened levels due to Fed normalization, Greek debt developments and unwinding of consensus trades. We therefore feel it is important to be tactical in our positioning in risk assets and keep some powder dry to take advantage of opportunities arising from the increased volatility.
- Within equities, we maintain our preference for markets outside of North America where we see more attractive valuations, central banks on an easing cycle and weakening currencies, which should help exports and earnings.
- We have a negative view on government bonds and are currently underweight duration, particularly in the US and Japan. Investment grade credit should see increased demand, as sovereign bonds have low to negative nominal yields, making investment grade corporates increasingly attractive.

Current views[1]

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

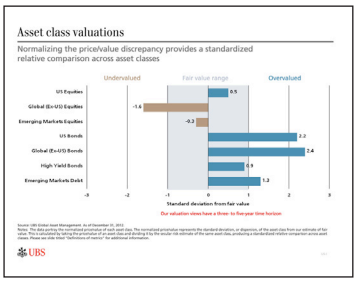


Asset Class	Overall signal	UBS Global Asset Management's viewpoint
US Equities		• While we remain constructive on global equities, we are seeing more opportunity outside of North America, where we see attractive valuations and central banks committed to easing. • US margins have remained resilient but may face future pressure amid an improving labor market (rising wages), a rising US dollar and Fed rate normalization. Earnings growth is losing momentum and is at risk of heading lower in upcoming quarters.
Global (Ex-US) Equities		• Certain markets outside of the US, such as Europe, the UK and Japan, look attractive. Market sentiment has turned more bullish, and we feel there is still room for this to continue, as economic data has been coming in stronger, albeit from anemic levels. • We see scope for further gains in Europe as the euro weakness positively impacts earnings and lending growth increases. It is important to see earnings growth in order for the current undervaluation gap to close. Keeping the Grexit situation (Greece's exit from the eurozone) in check, as well as preventing separatist movements in countries like Spain, is important. • Japan's equity rally has been based both on structural changes (corporate tax cut, improved shareholder focus, increased buybacks and payouts) and cyclical forces (the yen's weakness and oil price decline benefit Japanese exporters).
Emerging Markets Equities		• While from a valuation perspective emerging markets appear broadly attractive, lack of real productivity gains and structural reforms put them at risk. This is particularly the case during periods of falling oil prices and a rising US dollar. • Opportunity is arising from this global backdrop, and we prefer North Asian emerging markets over the broader emerging market index. These countries are less exposed to geopolitical risk and structural issues, and are net importers of oil.
US Bonds		• We are currently undwerweight duration and prefer long-dated Treasuries over short-dated bonds, as we believe further flattening is to come in advance of the Fed raising rates. • Future inflation risks are currently priced as non-material despite continued progression of employment data (e.g. wage pressure). • Policy risk is high, and volatility should be expected with each Federal Open Market Committee (FOMC) meeting.
Global (Ex-US) Bonds		• European Central Bank QE has pushed bond yields to extreme lows and even negative in some cases, and we are starting to see some unwinding of that position. Monitoring the Grexit situation will be key for all European asset classes. • Japan continues to look attractive as a funding leg due to extremely depressed yields and a flat curve structure. The Bank of Japan remains a risk to a short position as it is a large buyer of government bonds, and we continue to monitor the central bank's action. • UK gilts offer relatively attractive yield and have some potential for spread compression in the long term. However, inflation expectations have been rising, as investors expect that the European Central Bank's quantitative easing policy will succeed in pushing consumer prices higher.
Investment Grade Corporate and High Yield Bonds		• Given negative bond yields across a large portion of European debt, we expect significant flows into investment grade corporates, as investors see the asset class as a close substitute to government bonds. • The spread on high yield has improved significantly from only a year ago, and we feel that investors are now appropriately compensated for the risk taken. We remain diligent in monitoring potential liquidity issues.
Emerging Markets Debt		• Emerging markets debt is now offering attractive yield, in our view, but a granular view by country is necessary as commodity exporting countries face the adverse impact on both the current accounts and their ability to service debt due to falling commodity prices. • Our preference is for emerging markets debt in hard currency due to potential emerging markets currency weakness in the short term.
Currency		• We continue to believe we are in a USD strengthening environment based on the economy's strength, the prospect for higher rates and the US dollar's comeback as a stronger reserve currency. We see particular appreciation potential against the New Zealand dollar and Australian dollar. The major risk at the present stage is that the USD is over-owned in the market. • The surge in the Swiss franc following the removal of the cap against the euro in January is overdone in our view. Relative purchasing power parity would argue for a significantly weaker Swiss franc, particularly against the euro. Deterioration of Swiss balance of payments surplus indicates that Swiss franc strength is unlikely to be sustainable.

[1] Source: UBS Global Asset Management. As of May 31, 2015.

Market behavior analysis complements valuation

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



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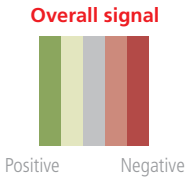


Market themes

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

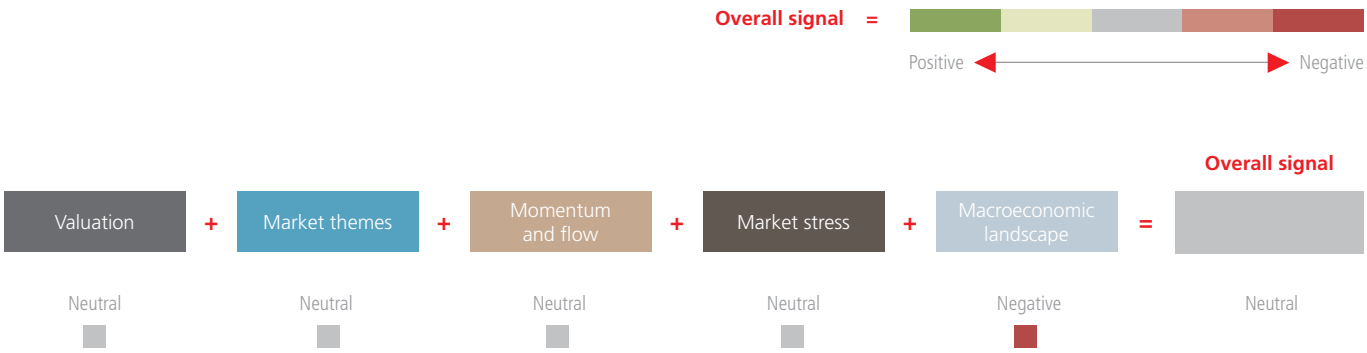
We created a proprietary stress index to help gauge price dislocations and investor risk appetite. It comprises several spread measures across credit markets, currencies and cash markets, as well as measures of market sentiment, such as the Chicago Board Options Exchange Market Volatility Index (VIX).

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 May 31, 2015

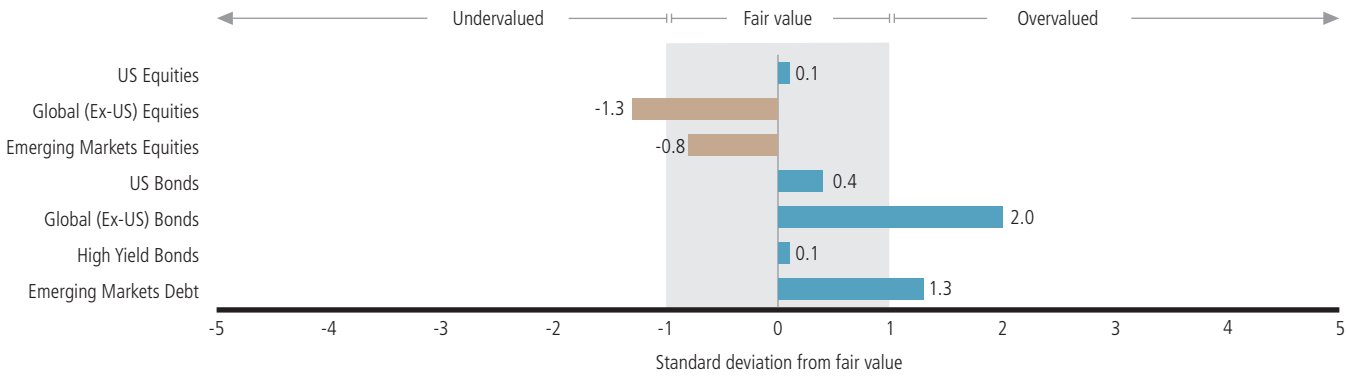
Valuation and market behavior indicators at work



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 Global Asset Management's views. As of May 31, 2015.

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 nonreinvested 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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