Asset Allocation Quarterly

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For global professional / qualified / institutional clients and investors and US retail clients and investors.

Macroeconomic themes | UBS Asset Management
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UBS

In our view, medium-term macroeconomic trends are the principal driver to global markets.

Contents

Macro matters

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Welcome to the first edition of Asset Allocation Quarterly.

For many years in the wake of the financial crisis, the 'lower for longer' narrative dominated the macroeconomic backdrop. Medium-term macroeconomic trends are still the principal driver to markets. For multi asset investors the big picture backdrop to markets is, in our view, simultaneously more complex and more opportunity-rich.

The macroeconomic and asset allocation views expressed in this publication are therefore structured around a selection of those key global macroeconomic themes. We focus here only on those we believe offer attractive opportunities on a risk-adjusted basis both within and across asset classes over a three- to twelve-month tactical asset allocation investment time horizon.

As the following pages detail, we currently identify five such themes that we believe are likely to be the major drivers of investor returns in the coming months.

Those themes are:
– Geopolitics and protectionism
– Higher volatility
– Moderately higher bond yields and inflation
– The monetary policy balancing act
– Global growth steadies above trend

We explore the current dynamics of each theme and outline the potential milestones that might support or challenge our expectations of its likely path. We also outline our preferred trades for accessing each theme across equity, rates and foreign exchange markets globally.

Over time our list of core themes will inevitably evolve — as the likely impact of current themes wanes and as potentially bigger macroeconomic trends and opportunities come into focus.

But the thematic structure of Asset Allocation Quarterly reflects precisely the framework we use day to day for macroeconomic analysis, debate and tactical asset allocation ("TAA") decision-making within the Asset Allocation and wider Investment Solutions teams. These themes are therefore the key drivers to TAA positions across multi asset portfolios[1].

Erin Browne,
Head of Asset Allocation

"For multi asset investors the big picture backdrop to markets is, in our view, simultaneously more complex and more opportunity-rich."

[1] Portfolio themes and associated trades are subject to change and may not be represented in all multi asset portfolios subject to specific investment objectives and restrictions

Macro themes

The key macroeconomic trends that are likely to be the major drivers of global markets over the coming year

Global growth steadies above trend

Higher volatility

Moderately higher inflation and bond yields

Geopolitics and protectionism

The monetary policy balancing act

Global growth steadies above trend

Highlights

- The global growth impulse has moderated and become less synchronized internationally
- But the overall demand backdrop remains resilient, healthy and above trend with continued employment and wage growth supporting consumption across the developed world
- The absence of significant imbalances suggests a low probability that global demand will decelerate sharply in the coming year
- Recent China stimulus is likely to cushion domestic demand and support wider emerging market growth

The rate of acceleration in global economic growth has moderated from the very strong levels in 2017 and early 2018. Growth rates by country and region are also more differentiated and less synchronized — with the relative strength of the US amidst this moderation a noteworthy development.

But while the pace of acceleration in the global economy has cooled and the principal drivers have narrowed, the residual growth rate remains resilient, relatively robust and above-trend. With monetary policy in aggregate still accommodative, we do not see the recent moderation as heralding a more meaningful demand downturn. Continued employment growth across major developed economies is supporting global consumption while accelerating wage growth in tight labor markets is likely to provide a further boost. Importantly, household leverage in aggregate does not appear stretched. Elsewhere the most recent global manufacturing PMIs are similarly consistent with a healthy underlying growth rate. In our view, the rundown in manufacturing inventories evident in the PMI data year-to-date also bodes well for a renewed acceleration in output growth in the coming months.

Importantly, we see few obvious structural imbalances that might precipitate a sharp deceleration in demand growth. Our own recession probability models continue to suggest that the likelihood of a recession in the coming year to eighteen months is low.

We see the main risks to global growth as threefold:

- Rising geopolitical risks as the US/China trade stand-off escalates materially beyond recent announcements and amidst an uncertain political backdrop in the Eurozone and in select emerging market countries
- China fails to rebalance its economy, reduce leverage and financial sector risk without prompting a sharp demand slowdown at a time when US sanctions are starting to bite
- Faster-than-expected rise in inflation and rates in the US, tightening financial conditions and undermining economic activity

None of these scenarios is our base case, and we expect global growth to at least partially resynchronize once again as ex-US demand picks up from its current low levels and the recent Chinese stimulus kicks in.

In the US, while the Federal Reserve (Fed) is raising short-term interest rates, it is doing so very slowly, with great transparency and with data dependence. Crucially in our view, real policy rates are around zero. A recent speech from Fed chair Jerome Powell confirmed the Fed's commitment to data dependence and that a gradual approach to policy normalization remains appropriate against a backdrop in which there are "no clear signs" of inflation accelerating sustainably above the key 2% level.

Meanwhile, the Fed has been unwinding its balance sheet precisely as it said it would a year ago, and may now end the reversal of Quantitative Easing earlier than expected. Whether the Fed goes through with this or not, what is very clear is that it will maintain a significantly larger residual balance sheet than it did prior to the onset of QE. We see this as positive for global demand and for avoiding a more abrupt growth slowdown.

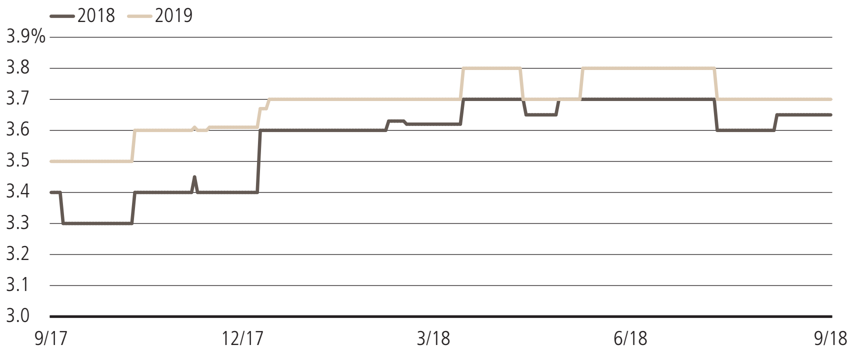
While there are good arguments that the strength in US economic data in the calendar second quarter is "as good as it gets," we see a vibrant economy that is currently sustainably supported on all fronts. Importantly, the drivers of demand in the US remain broad based and healthy. Consumption growth remains supported by very strong labor markets, accelerating wage growth and by a prudent savings rate that has room to fall without being unduly concerning. Strong capital investment is similarly consistent with continued growth in factory output. Strong US equity markets are also driving higher net wealth. And while the impact of some elements of the recent tax code reform are likely to be short lived, the full effects of a commitment to higher public spending and the potential boost to corporate capital expenditure are, in our view, yet to be fully realized.

Outside of the US, the monetary policy stances of the European Central Bank and Bank of Japan remain unequivocally loose and stimulative to demand. Data in both regions in the calendar first half was disappointing, but more recent updates show a welcome stabilization of demand growth. We see the potential for both regions to reaccelerate later in the year. The unwinding of emergency policy conditions in both regions, which we already believed would be gradual, may now take place over an even more extended period.

Within the major economic regions, we believe the most likely catalyst to a rebalancing of global demand may come from China. Recent data from the world's second largest economy has been disappointing, with the housing market the one bright spot as the authorities' crackdown on pollution, excess capacity, high debt levels, inefficient capital allocation and financial sector risks continues apace. The Chinese authorities have already taken a number of steps towards cushioning this growth slowdown. And with monetary, fiscal and regulatory policy levers at their disposal, there is plenty of flexibility for China to do more should it prove necessary.

The more balanced policy approach already in evidence should ease investor concerns about whether China is serious about addressing deleveraging and able to negotiate adroitly the difficult balance between short-term growth and long-term financial stability. While further measures to support Chinese demand are likely, we certainly do not expect the authorities to engage in the sort of reflationary stimulus that it executed in 2009 and 2015.

Exhibit 1: Global GDP YoY% forecasts (Bloomberg consensus)



Source: UBS Asset Management, Bloomberg as at Q3, 2018

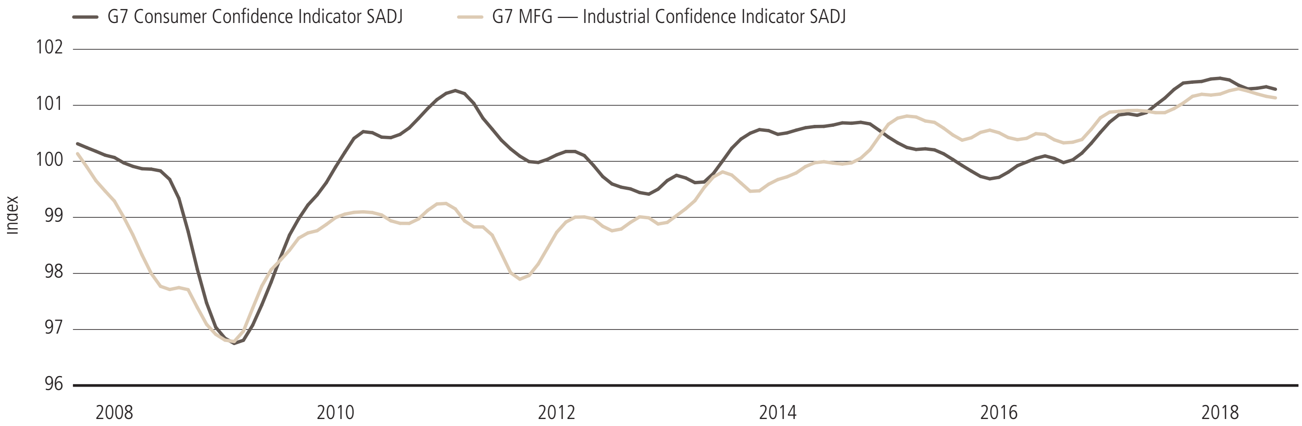
Figure 2: Potential supports and challenges to our theme base case

✓	Business investment continues to rise, supporting productivity
✓	Labor markets continue to strengthen, boosting consumer confidence and spending
✓	Fiscal policy supportive in countries/regions with low public debt
✗	Global PMIs decline towards 50, separating expansion from contraction
✗	US recession tracker probabilities rise
✗	Tariffs meaningfully disrupt supply chains, weigh on business confidence and slow investment

Figure 3: Asset class implications

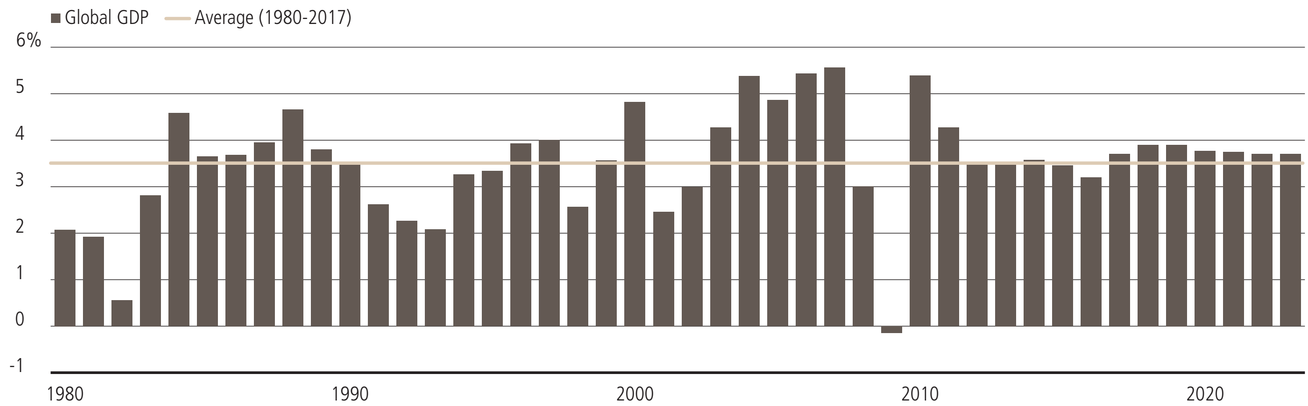
Asset class	View	Overall signal	Theme trades
Equities	– While risk-adjusted returns are strongest when growth is accelerating, equities still post positive gains when growth is stable and above trend. – A less synchronized growth outlook implies stronger equity performance for outperforming economies. As long as the US economy is expected to outperform, US equity markets are relatively attractive.	Neutral to positive More selective on regional exposure	L MSCI World L Nasdaq vs S&P 500 L EM Standard & Min Vol vs S&P 500
Fixed income	– Above trend growth amid closing or closed output gaps will put upward pressure on inflation. This suggests an underweight to duration. – In addition to strong cyclical growth, a pickup in either labor participation or productivity signifies stronger potential growth. This would allow long term yields to reprice higher. That said, there is currently a great deal of uncertainty on the outlook for potential growth. – Despite recent volatility, a stable global growth environment is positive for emerging markets, which have repriced considerably.	Negative	S Global duration L US Breakeven L Asian bonds Hard Currency
Currencies	– In a vacuum, strong global growth is consistent with outperforming high beta and EM FX. – Strong global growth is consistent with higher yields, encouraging outflows from safe havens like Switzerland.		S USDMXN L EURCHF

Figure 4: Forward looking data remain healthy — G7 lead indicators



Source: UBS Asset Management, Bloomberg as at Q3, 2018

Figure 5: Global GDP (IMF forecasts 2018-2023)



Source: UBS Asset Management, Datastream as at Q3, 2018

Higher volatility

Highlights

- We expect a moderate increase in the overall volatility regime as the range of potential growth, inflation and interest rate outcomes broadens and as geopolitical risks take center stage
- While the Fed will retain a much larger balance sheet than it did prior to the financial crisis, the partial reversal of its Quantitative Easing program is also likely to result in a modest increase in overall volatility regime for asset classes globally
- A stronger USD plus divergent growth paths among major economic areas could also threaten higher volatility

The current US expansion is already the second longest in the post-war period. As the cycle matures, the range of potential growth, inflation and interest rate outcomes is broadening from the very narrow range investors have been used to for much of the past decade post financial crisis. At a very simple level, this increasing degree of uncertainty, albeit modest, is likely to result in an increase in the overall volatility regime for all US asset classes.

Overall liquidity conditions have also been a key driver of volatility historically. While global central bank liquidity in aggregate continues to grow due to ongoing quantitative easing programs from the European Central Bank and Bank of Japan — and interest rate rises in both regions look some way off — the importance of the dollar to the global economy vis-à-vis other currencies means the actions of the Fed matter to investors disproportionately. As we highlight elsewhere in this publication, we continue to believe that the Fed will normalize US monetary policy only gradually and only if the data warrants such action. Fed chair Jerome Powell has made this clear in recent public speeches. Moreover, while the Fed is reversing the process of Quantitative Easing it will almost certainly retain a much larger residual balance sheet than existed prior to the onset of QE in late 2008. Nonetheless, even while real rates in the US are around zero, monetary policy in the US is slowly becoming less accommodative. And since the purpose and result of Quantitative Easing was to encourage risk-seeking behavior and suppress asset class volatility, its partial reversal suggests, all else equal, that investors' overall risk appetite is likely to moderately decrease and volatility increase.

Historically, the initiation of a US interest rate tightening cycle leads a rise in equity market volatility by approximately two and a half years. That relationship appears to have held true in this cycle too. Investor concerns about the exposure of emerging market countries to a stronger US dollar and higher USD funding rates have increased notably since mid-year, two and a half years since the first hike in the Fed Funds rate in this cycle in December 2015.

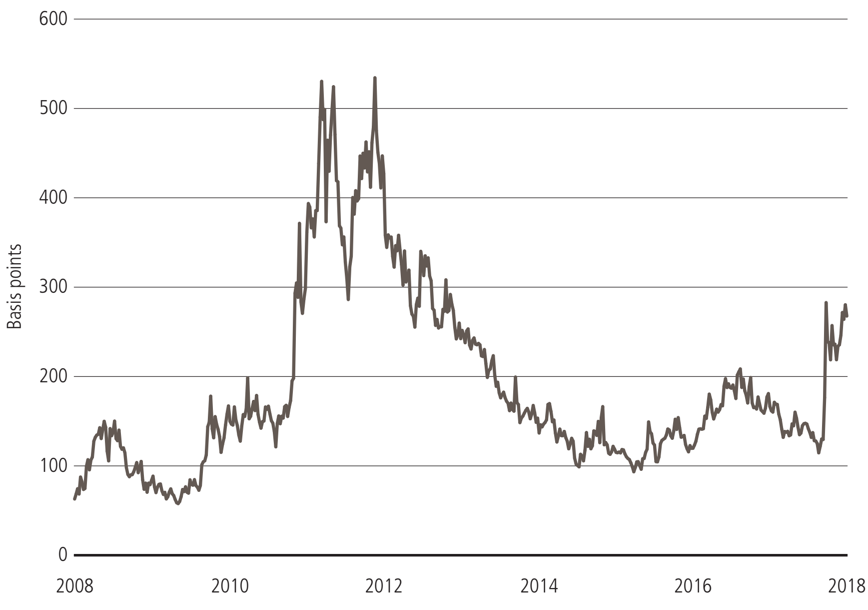
While we continue to believe that returns for major asset classes will still be positive over the medium-term, returns from risk assets are likely to be more muted and significantly lower on a risk-adjusted basis than they have been for much of the post-crisis period.

In our view, continued US dollar strength may also prompt higher volatility globally. Recent support for the US dollar primarily reflects that global growth has become desynchronized, with the sustained robustness of US demand and accompanying higher interest rates standing in ever sharper contrast with the moderating growth profile and loose monetary policy of other major developed economies. Against this backdrop, it is not surprising that the trade-weighted dollar has continued to rise. For EM countries with significant external funding requirements and large current account deficits this backdrop is clearly far from ideal. In addition to Turkey, we would highlight countries including Argentina, Colombia and South Africa. But while a stronger US dollar threatens higher volatility in risk assets in general and EM in particular, our view is that that EM overall is in much better shape than during the 2013 Taper Tantrum when similar fears arose about the impact on EM assets of tightening US financial conditions.

Finally, growing geopolitical risks, particularly with regard to global trade and the imposition of import tariffs, are likely to continue to impact markets globally and support a higher volatility regime for risk assets. While there are cyclical elements to some of these developments, we see the growth in economic nationalism as reflective of structural trends including ageing populations. The broad-based increase in popularity for alternative parties in Europe and the US, most of whom have higher fiscal spending as a key manifesto plank, are also likely to sustain a higher volatility regime.

Exhibit 1: New Italian government unnerving bond investors

Italian — German 10y government bond yields (basis points)



UBS Asset Management, Datastream as at Q3, 2018

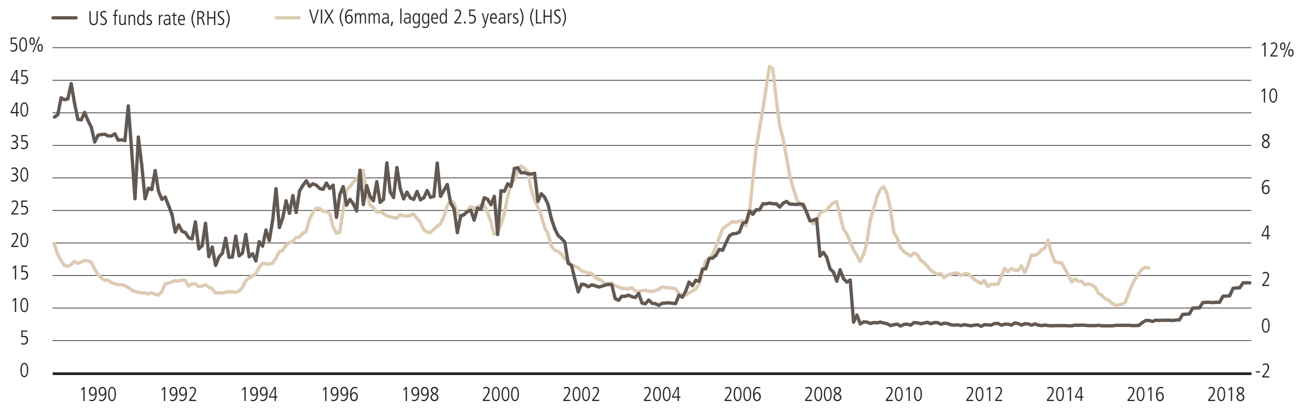
Figure 2: Potential supports and challenges to our theme base case

✓	Short-term rate markets begin to price in more tightening from the Fed
✓	Trade tensions continue to ratchet higher
✓	USD continues to strengthen, tightening financial conditions on emerging markets
✗	The Fed pauses its tightening cycle as it approaches neutral
✗	US-China trade truce
✗	Global growth re-synchronizes, placing downward pressure on USD

Figure 3: Asset class implications

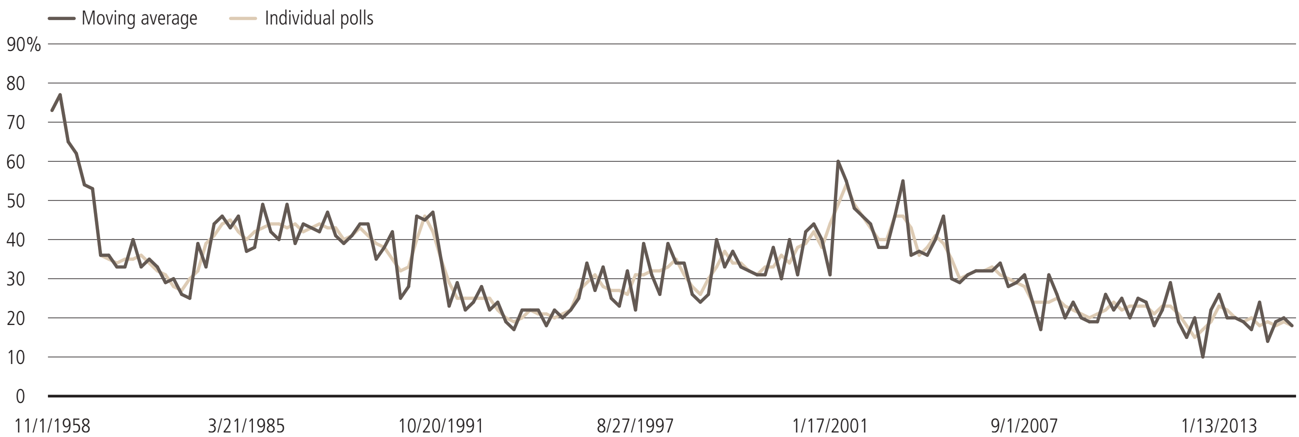
Asset class	View	Overall signal	Theme trades
Equities	– Modestly higher volatility is still consistent with positive equity returns. However, if markets enter a more prolonged regime of higher volatility, it is likely to weigh on risk assets. – There is a long history of energy performing well as the economy moves into late cycle. Rising geopolitical risks in the Middle East are hedged with energy exposure.	Neutral	L MSCI USA Energy vs. MSCI USA
Fixed income	– We are short duration as central banks gradually remove accommodation. – If inflation rises significantly, both equities and fixed income could be challenged – A severe and prolonged rise in volatility due to growth concerns would likely lead to a flight into safe assets, challenging the short duration view.	Neutral	S US 5yr HY CDS S Global Duration
Currencies	– We are short various high beta and commodity currencies to hedge against a volatility pick up. – Safe haven currencies, such as USD, JPY, and CHF should outperform in more volatile environments.		S AUDUSD S USDJPY L JPYKRW

Figure 4: Higher volatility as US rates rise? US fed funds (RHS, %) vs. VIX (LHS, lagged 2.5 years)



Sources: UBS Asset Management, Datastream as at Q3, 2018

Figure 5: Political disquiet a long-term theme? US public trust in government (1958-2017)



Sources: Pew Research Center, Jan 2018

Moderately higher inflation and bond yields

Highlights

- Reduction in globalization, higher trade tariffs, rising oil price are likely to push consumer prices higher globally
- As output gaps close in the developed world and wage growth accelerates from low levels we see core inflation and G10 nominal government bond yields edging higher
- Upside in both inflation and yield likely to be constrained by structural forces including ageing populations, technology advancements and rise of e-commerce

The 'lower for longer' narrative of low inflation and low interest rates driven by structural drivers such as globalization, abundant central bank liquidity, demographics and technology dominated the investment backdrop for a substantial period in the wake of the financial crisis. This highly consensual narrative led to continued downward pressure on nominal bond yields and to very low levels of volatility across global asset classes.

But since the second half of 2016 that narrative has been increasingly questioned and challenged. The yields of 10yr nominal government bonds of major developing economies have generally edged higher, albeit within a relatively limited range, with the most significant rises in the US where economic growth is most robust and inflationary pressures building.

Nonetheless our view remains that both global inflation and bond yields remain low in a long-term historical context and are likely to continue to move higher as output gaps close, wages continue to tick higher in the developed world due to very tight labor markets and as central bank liquidity is gradually withdrawn, paced by the US.

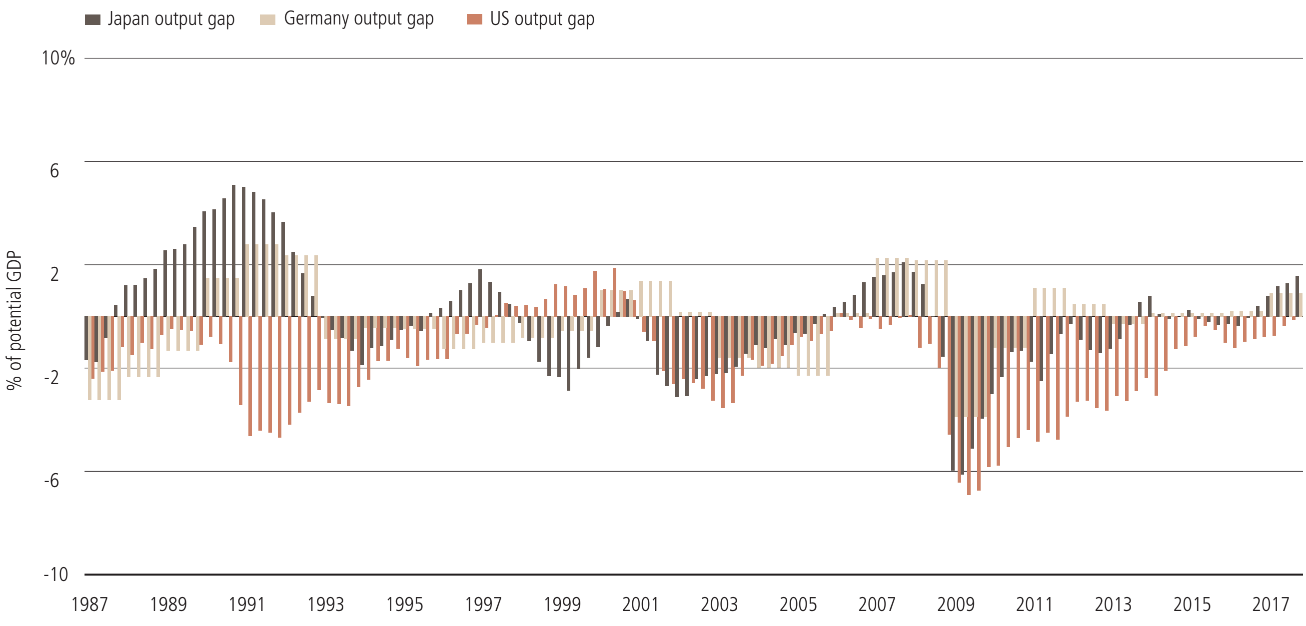
Our view is also that inflationary economic nationalism is on the rise. The theme is perhaps most stridently embodied by the 'America First' policy pursued by the US via an aggressive approach to trade agreements that have included the imposition of tariffs on a wide range of Chinese goods. At least in the short term, it seems clear that the forces of globalization are abating and there are already signs that trade tariffs are leading to higher prices. But some of the drivers of economic nationalism including ageing demographics appear more structural and long term in nature. Deglobalization may therefore be a more persistent theme than many investors currently anticipate.

However, while gradual deglobalization via incremental tariffs is inflationary, sharp escalation in the current trade stand-off to an outright disruptive significant trade war might hit growth more than it does prices — and could over time become deflationary if it prompts financial conditions to tighten to a sufficient degree to slow demand growth.

Meanwhile, some of the major disinflationary forces of recent years have either dissipated or reversed. The impact on consumer prices of the 2008-2009 financial crisis, the subsequent EM debt crisis and Chinese excess capacity have all largely worked their way out of the system. In place of austerity and fiscal restraint, there is now a greater focus on fiscal stimulus, paced once again by the US. Meanwhile, the oil price, a major input cost, has risen sharply from its lows of early 2016.

However, we do not expect a violent shift higher in inflation or nominal bond yields given that some structural deflationary forces remain in place. We expect technology advancements, the continued rise of e-commerce and its associated price transparency, ageing populations and low neutral rates across the developed world to continue to limit the upside for nominal bond yields and inflation.

Exhibit 1: Closing G3 output gaps



Source: UBS Asset Management, Macrobond as at Q4, 2017

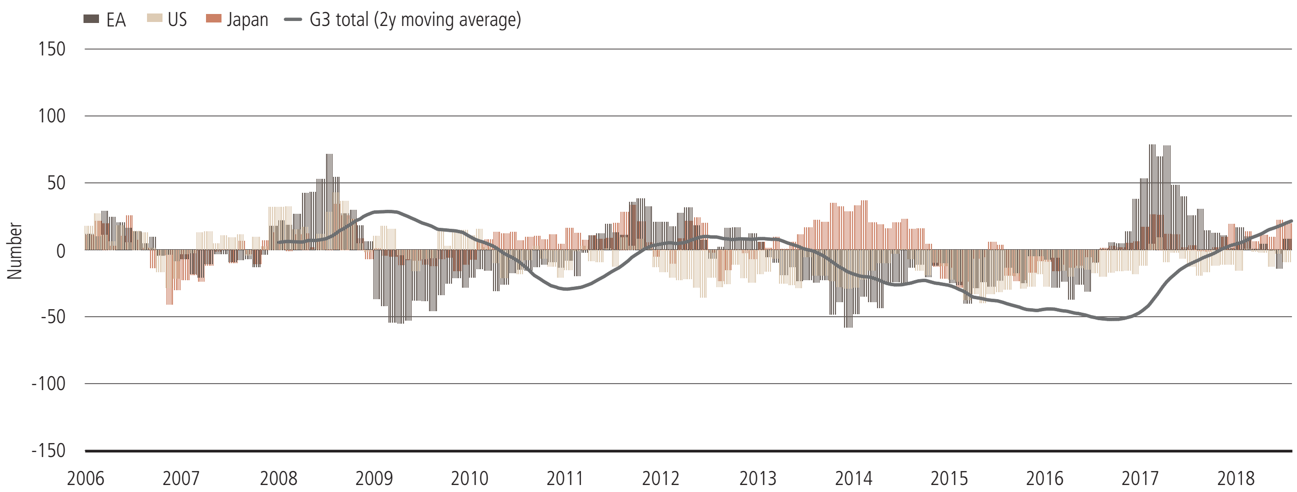
Figure 2: Potential supports and challenges to our theme base case

✓	Labor markets tighten further, supporting wage inflation
✓	Commodity prices boost headline inflation and support pass-through to core inflation
✓	Moderate trade restrictions imposed, boosting goods inflation
✗	Flat Phillips curves prevent inflation from responding to tighter labor markets
✗	Financial conditions tighten putting downward pressure on growth and inflationary pressures
✗	Outright trade war damages global growth and inflation prospects

Figure 3: Asset class implications

Asset class	View	Overall signal	Theme trades
Equities	– Equities and commodities tend to have positive returns in a late cycle environment.	Neutral	L MSCI USA Energy vs. MSCI USA
Fixed income	– Upward pressure on inflation suggests an underweight to duration.	Neutral	S Global duration L US Breakeven
Currencies	– In a vacuum, reflation is consistent with outperforming high beta and EM FX. – But with much of the global growth impetus coming from the US, the USD has been stronger against EM and currencies with large external liabilities. – The CHF tends to weaken amid higher global yields.		S USDMXN L EURCHF

Figure 4: Number of G3 inflation data surprises



Source: UBS Asset Management, Macrobond as at Q3, 2018

Figure 5: Labor market slack evaporating? G3 unemployment rates — OECD estimate of Non Accelerating Inflationary Rate of Unemployment

Source: UBS Asset Management, Datastream as at Q3, 2018

Geopolitics and protectionism

Highlights

- Rise of populism in developed markets (DM) is unlikely to be a short-term development and in our view this trend raises the geopolitical risk premium across asset classes
- Economic nationalism and protectionism with associated trade tariffs on imports, implicit rejection/reversal of globalization benefits are further extensions of these trends
- Shift from austerity to fiscal stimulus in DM likely to broaden and could help sustain demand cycle
- Idiosyncratic political risk and exposure to DM protectionism also remain key features of the emerging markets backdrop

Whether the financial crisis was the catalyst or, as some social economists have posited, merely a milestone in a longer-term trend, the rejection of the benefits of globalization and the orthodox political mainstream has become increasingly evident across the developed world in recent years. Growing support for non-traditional candidates and parties can be seen in the UK's Brexit vote, US presidential elections, and across a number of recent European elections.

Frustration at a two-speed economic recovery in the wake of the financial crisis that has seen the value of risk assets soar while many endure austerity measures is, in our view, at the heart of voters' discontent, alongside governments' impotence in, the face of global economic forces, in redressing the inequality created by unconventional monetary policy. More recently, controlling immigration and the perceived loss of the nation state have also become important issues behind the rise of nationalism.

For much of the post-crisis era, investors' concerns about geopolitical risks have been focused on Europe and the potential break-up of the Eurozone. Emmanuel Macron's election victory in France on a mandate of closer integration with Europe provided some respite.

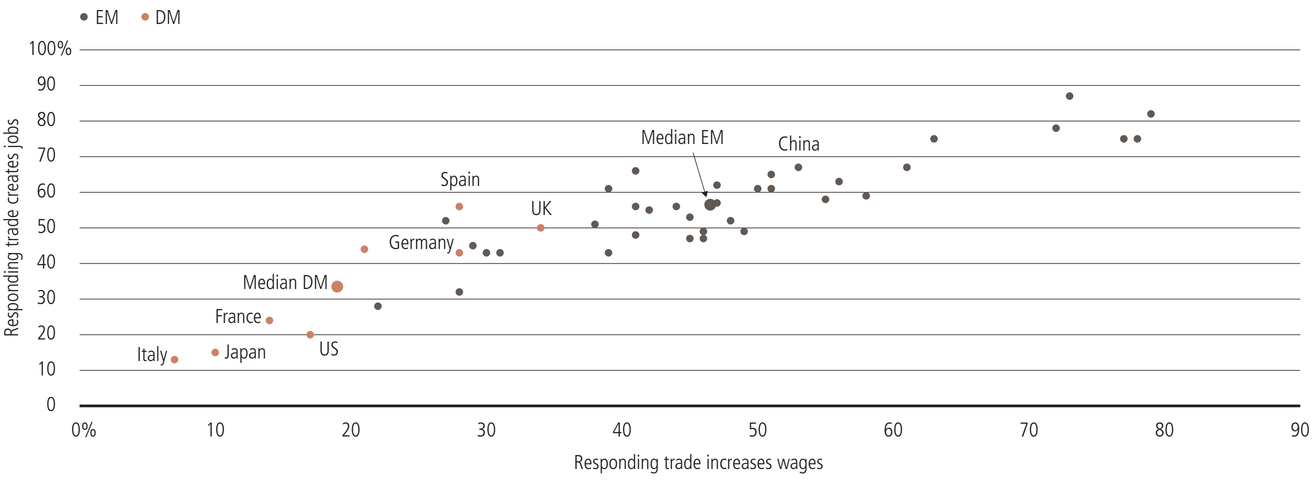
But the strong gains of alternative parties in Germany's 2017 elections and the formation of a new Italian coalition government comprising the anti-establishment 5 Star Movement and the right wing League parties on a manifesto of lower taxes and higher spending continue to unnerve investors. We believe that the political risk premium in European assets is likely to remain elevated with two non-mainstream parties leading an Italian government that may challenge the Eurozone's existing fiscal rules.

But the drivers to higher geopolitical risks have broadened beyond the Eurozone. The election of Donald Trump on a pledge to put 'America First' has seen free trade principles subordinated by political populism. The US has imposed wide ranging tariffs on Chinese goods. This reflects the desire of the current

US administration to address perceived Chinese intellectual property theft and a US current account deficit driven by Chinese currency manipulation that it sees as harming US job creation and wealth. However, the standoff between the US and China on trade risks higher costs and slowing growth globally should it escalate still further. Meanwhile, the US has imposed sanctions on Russia, Iran and Turkey among others as it uses trade policy and control of the dollar-based financial system to achieve its aims ahead of the November mid-term elections. Apart from the country- and industry-specific implications, these developments threaten slower growth and higher prices – as well as higher volatility across currencies and asset classes.

Meanwhile, political uncertainty in the UK remains high. At the time of writing there is still no clear agreement between the UK and the European Union over the trading relationship between the two once the UK officially leaves the EU at the end of March 2019. While large cap UK-listed equities are beneficiaries of a weak pound, it is currently sterling and long gilts that are the focus for investors' disquiet about the increasing probability of a so-called 'hard Brexit.' Adding to the volatility in GBP assets is the increasing likelihood of a renewed battle for the leadership of the ruling Conservative Party in the coming months.

Exhibit 1: Contrasting perception of benefits of trade between Emerging Markets (EM) and Developed Markets (DM)



Source: Pew Research Center, Q3 2018

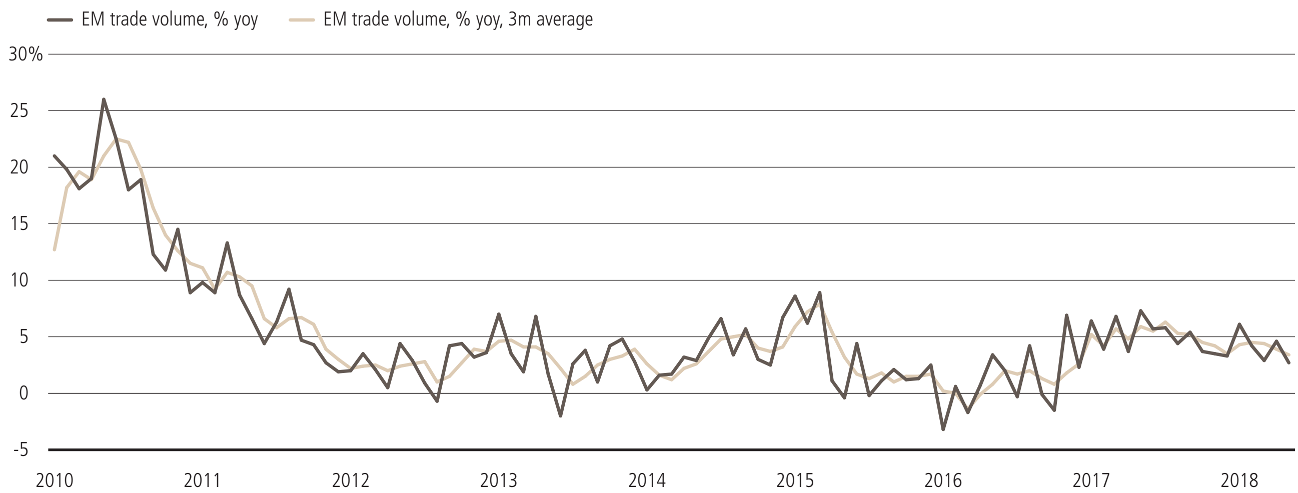
Figure 2: Supports and challenges to our theme base case

✓	Further escalation of anti-trade measures between the US and China
✓	Trump administration places tariffs on auto imports
✓	Failure to renegotiate NAFTA creates uncertainty on regional business ties
✗	US-China trade truce
✗	Trump administration backs away from auto tariffs; broader trade agreements achieved with US allies
✗	NAFTA 2.0 signed and passed by all three parties before year-end 2018

Figure 3: Asset class implications

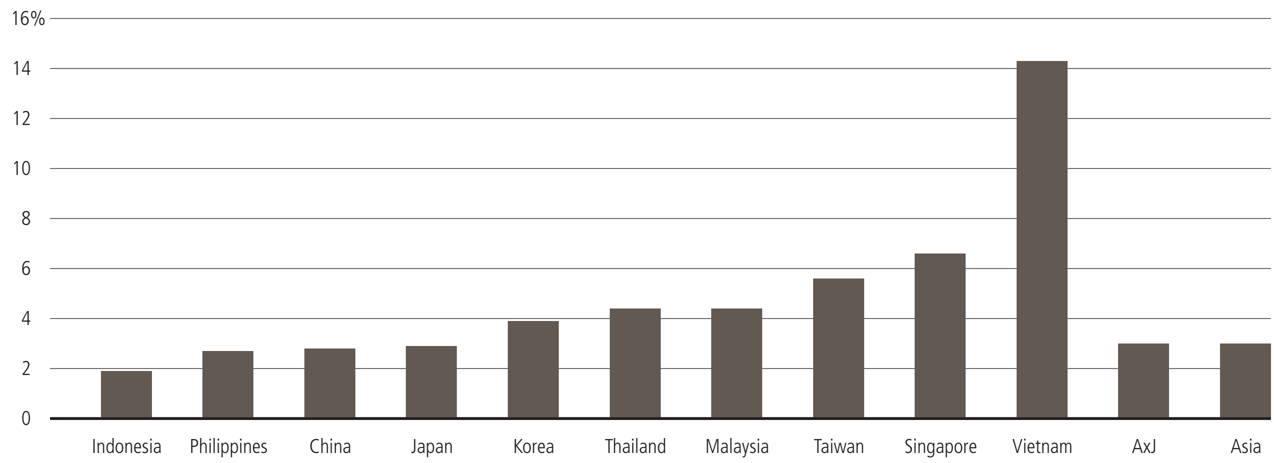
Asset class	View	Overall signal	Theme trades
Equities	– Both trade and immigration restrictions tend to reduce growth and profits via increased costs. – However, trade-reliant companies will be hurt more than those with mostly domestic revenues and costs. – Cyclicals would underperform defensives. Some regions may be more susceptible to rising trade tensions than is currently priced in.	Negative	L China H vs MSCI Taiwan
Fixed income	– Upward pressure on inflation suggests an underweight to duration. – Downward pressure on growth is negative for credit spreads.	Negative	S US 5yr HY CDS S Global Duration
Currencies	– EM currencies are high beta to both global growth and trade. – Safe haven currencies, such as USD, JPY, and CHF should outperform regardless of the nature of a geopolitical shock.		S AUDUSD S USDJPY L JPYKRW

Figure 4: Emerging Market Trade Volume



Sources: UBS Asset Management, Capital Economics as at Q2, 2018

Figure 5: Value-Added Exports to the US (% of GDP, both direct and indirect via China)



Sources: UBS Asset Management, CEIC, HSBC as at Q3, 2017

The monetary policy balancing act

Highlights

- Contrast between the strength of the US economy and the rest of the developed world has grown starker in recent months
- Against this backdrop the US Federal Reserve is alone among G3 central banks in pursuing a meaningful policy tightening regime
- The decoupling of monetary policy among developed nations is creating opportunities across asset classes

If synchronized growth was the defining feature of the global economy in the second half of 2017 and in early 2018, more recent data has seen a sharp reversal of that trend. Spurred in no small part by the significant fiscal stimulus to the US economy at a time of near full employment, the contrast between the continued economic strength and rising prices of the US and the significantly more moderate growth and inflation dynamics in other major economies has grown starker.

Against this backdrop, the US Federal Reserve (Fed) is pushing ahead with policy normalization and interest rate hikes at a time when the Fed's European and Japanese counterparts await more compelling evidence that a sustained pickup in core inflation is underway. Indeed, given the relative weakness in developed world data outside of the US, we believe that monetary policy is likely to stay looser for longer in both the Eurozone and Japan.

The Bank of Japan (BoJ) recently tweaked its official yield curve control policy by broadening the upper and lower yield limits at which it continues to buy 10-year government bonds to support the economy. But any interpretation of this as a tightening step needs to be taken alongside a downgrade to the BoJ's inflation expectations and the introduction of forward guidance that promised to keep yields low for an extended period. The BoJ has also hinted that a hike in official short-term policy rates is unlikely until after the scheduled VAT tax hike in Japan in 2019.

Recent rhetoric from the European Central Bank (ECB) has been similarly dovish. In announcing a tapering of its quantitative easing program to zero by the end of 2018, the ECB also reassured investors that rate hikes will not come before summer 2019. In the meantime, the ECB continues to reinvest the significant proceeds from maturing bond holdings.

In many other G10 economies, high household leverage also makes it difficult for local central banks to raise interest rates. In particular, concerns about high levels of consumer debt continue to put downward pressure on G10 currencies such as the Australian dollar and New Zealand dollar versus their US counterpart.

In our view, while much of the global central bank divergence is already reflected in currencies and asset prices, there is a growing risk that a global slowdown may occur before many central banks outside of the US have been able to meaningfully raise interest rates off their lows. This clearly reduces the scope for subsequent rate cuts in the future should the demand environment deteriorate significantly.

In emerging markets (EM), tighter Fed policy and a stronger USD are pressuring some central banks in countries including India into a difficult decision — tighten policy in line with the US or allow currencies to weaken and drive inflation higher through higher import costs. Elsewhere within EM, central banks in China and Korea are more focused on shoring up local growth and inflation by keeping rates low.

Having grown an extremely healthy 4.0% in Q2, we are watching to see whether the US economy can continue to grow at its current robust pace and whether core PCE inflation will trend sustainably higher above the key 2% threshold. If it does, the Fed is likely to push on with rate hikes.

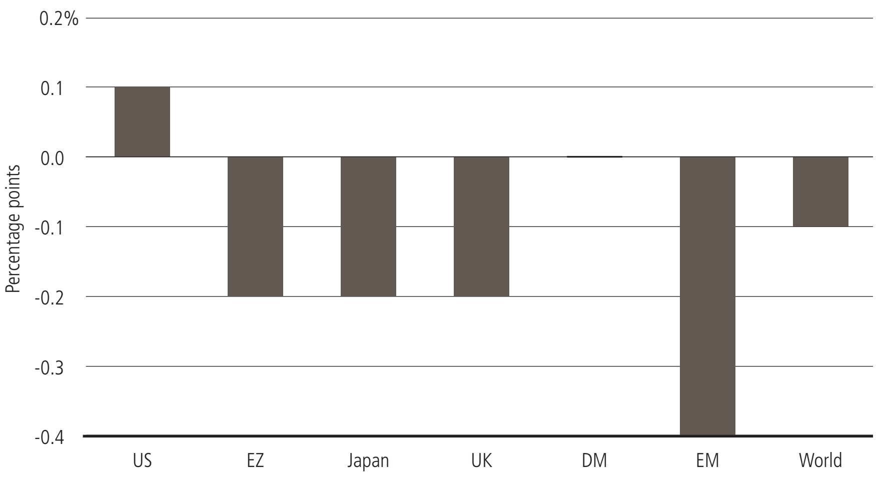
At the time of writing, the market is pricing in a high probability of one further 25bp hike in December following the September rise, plus two further quarter point hikes in 2019. This compares with the three hikes for 2019 embedded in the so-called 'dot plot' showing the projections of the Fed's 12-strong rate setting committee.

Further hikes and Fed guidance in favor of more tightening will add support to this theme. On the other hand, if financial conditions tighten such that US growth falters and the Fed backs off, or if the Fed gives guidance that it feels it is close to its terminal rate and unlikely to move into restrictive territory, this would lead the market to reprice Fed hiking expectations in a dovish direction and work against the theme.

Inflation remains quite subdued in economies like Japan and Europe. If it remains so, central bank divergence is likely to continue. However, if growth picks up and core inflation begins to trend higher outside the US, it will eventually put pressure on other central banks to hike alongside the US.

The evolving outlook for monetary policy across countries and regions is likely to be a rich source of investment opportunities across asset classes as central banks address the difficult balancing act between supporting growth and controlling inflation, and as rate expectations discounted in asset prices change over time.

Exhibit 1: Change in 2018 GDP Forecasts since end of Q1



Source: UBS Asset Management, Bloomberg as at Q3, 2018

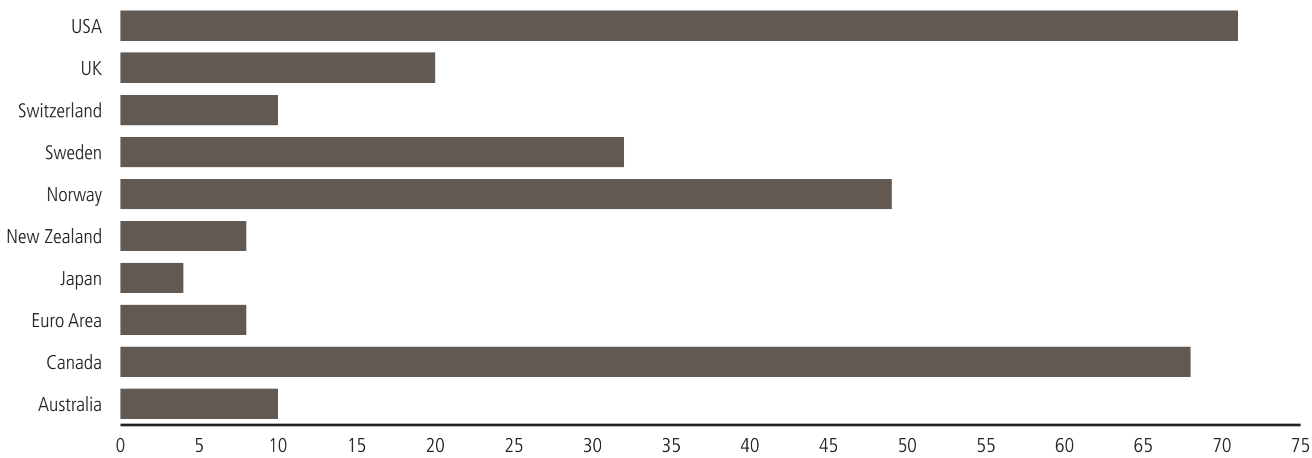
Figure 2: Supports and challenges to our theme base case

✓	US growth and inflation accelerate further
✓	Fed hikes faster and by more than implied by market pricing
✓	PBOC allows interest rate spread to US to narrow further
✗	Ex-US growth and core inflation pick up
✗	The Fed signals a pause as it approaches estimates of R* (natural real rate of interest)
✗	China eases fiscal policy, supporting ex-US growth

Figure 3: Asset class implications

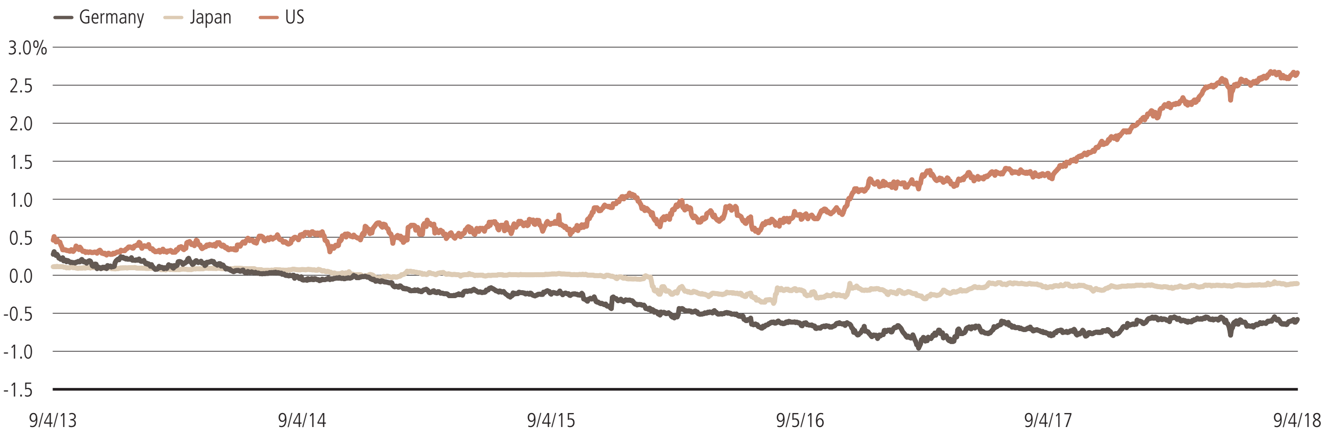
Asset class	View	Overall signal	Theme trades
Equities	– Moderately higher inflation and yields are not inconsistent with a positive view of equities as long as corporates are able to pass on higher costs and as long as monetary policy is not restrictive.	Neutral	
Fixed income	– As the US is the global monetary anchor, the removal of US policy accommodation should put upward pressure on bond yields globally. – That said, easy monetary policy in Europe and Japan should limit how much yields can rise in the US. – Tighter Fed policy is consistent with late cycle behavior and a short HY position.	Negative	S Global duration S US 5y HY CDS L AUS 3 YR L CAD 10y v US 10Y
Currencies	– The USD is facing cross-currents including diverging monetary policy (bullish) with overvaluation and a later US cycle (bearish). We keep a fairly neutral net USD position. – We focus our long USD positions against countries where central banks may find it difficult to raise rates amid high leverage, such as Australia and New Zealand.		S AUDUSD L USDCAD

Figure 4: Market-implied cumulative hikes in official short-term interest rates 12m ahead (bps)



Source: UBS Asset Management, Bloomberg as at Q3, 2018

Figure 5: Diverging policy: US, German, Japan 2y government bond yield



Source: UBS Asset Management, Datastream as at Q3, 2018

Trades by theme

Our favored trade expressions of each macroeconomic theme

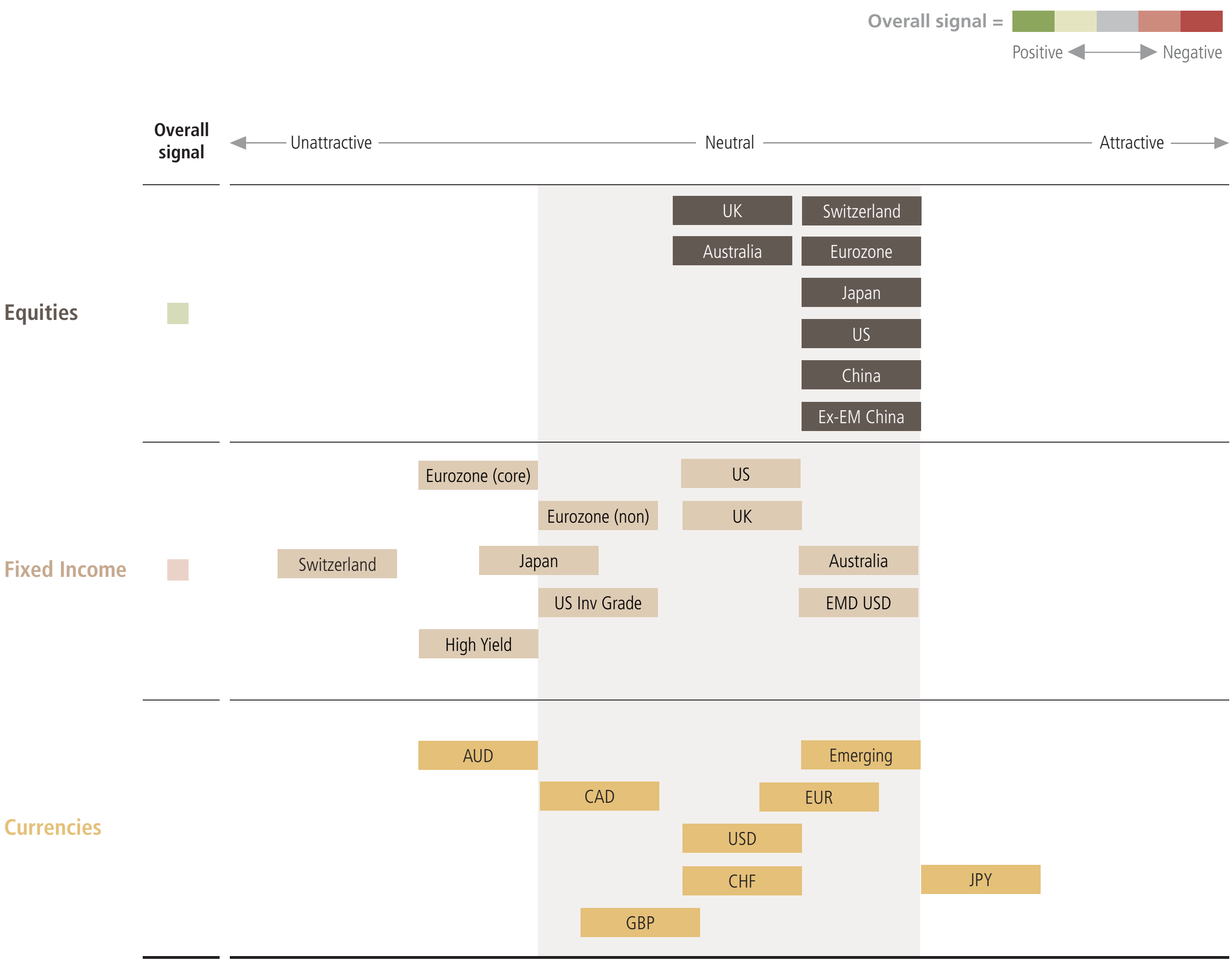
Exhibit 1: Trade summary by theme

Theme	A/C	Trade
Global growth steadies above trend	EQ	L MSCI World
	EQ	L Nasdaq vs S&P 500
	EQ	L MSCI US Energy vs. MSCI USA
	FI	S Global duration
	FX	S USD v MXN
	FX	L EUR v CHF
Higher volatility	EQ	L MSCI USA Energy v MSCI USA
	FI	S Global Duration
	FI	S US 5y High Yield CDS
	FX	S AUD v USD
	FX	S USD v JPY
	FX	L JPY v KRW
Moderately higher bond yields and inflation	EQ	L MSCI USA Energy vs. MSCI USA
	FI	S Global duration
	FI	L US Breakeven
	FX	S USDMXN
	FX	L EUR v CHF
Geopolitics and protectionism	FI	S US 5yr HY CDS
	FI	S Global Duration
	FI	L US Breakeven
	FX	S AUDUSD
	FX	L USDCNY
	FX	S USDJPY
	FX	L JPYKRW
The monetary policy balancing act	EQ	L EAFE vs US equities
	FI	S Global duration
	FI	S US 5y HY CDS
	FI	L AUS 3 YR
	FI	L CAD 10Y vs US 10Y
	FX	S AUDUSD
	FX	L USDCAD

Note: Trade ideas are subject to change without notice. Inclusion in Multi Asset portfolios dependent on specific portfolio return objectives and risk parameters.

Asset class attractiveness

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of September 30, 2018.



Source: UBS Asset Management Investment Solutions Asset Allocation team as at September 30, 2018. Views are provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change. For illustrative purposes only.

Overall signal =

Positive ◄—► Negative

Asset class	Overall signal	UBS Asset Management's viewpoint
US Equities		– While the US economic cycle is mature, both consumer spending and corporate capital expenditure appear well supported by recent tax reform. The latter in particular gives grounds for optimism in future US productivity growth and in the sustainability of the cycle. – Stronger-than-expected corporate earnings growth, rising M&A and increasing capital returns to shareholders are likely to remain key supports in the coming months. Indeed, US equity valuations are now more attractive after recent profit growth has outpaced share price performance. More importantly in our view, US equities remain attractively valued relative to bonds despite the recent rise in yields.
Global (Ex-US) Equities		– In Europe, the increased risk premium prompted by recent political developments in peripheral Europe will likely constrain upside potential until more clarity emerges around the fiscal intentions of the new Italian government. Despite these short-term headwinds, our longer-term base case remains positive, supported by demand growth that is still above trend, and the potential support to earnings from re-gearing. – In Japan, core inflation remains muted despite the closing of the output gap. This supports a very gradual adjustment of current loose monetary policy. We view Japanese equities as moderately attractive.
Emerging Markets (EM) Equities including China		– Emerging market equities have struggled in recent months in the face of a strengthening USD, rising USD funding rates and rising geopolitical risks. We do not dispute that these factors present headwinds. But in aggregate fundamental conditions remain relatively robust and the recent share price weakness across EM feels out of kilter with these fundamentals. – We no longer have a clear preference for Asia (ex China) within the broader EM universe. In our view, attractive valuations are now at least partially countered by vulnerability to any escalation in the US/China trade war. – We remain broadly positive on China. Any broadening of the current trade stand-off with the US is likely to hamper Chinese growth, but a gradual economic slowdown is already priced in and the Chinese authorities have already shown themselves willing to boost liquidity to help smooth the ongoing economic transition. Chinese equities still trade at a PE discount to other markets and further market liberalization could prompt a rerating as international capital starts to flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
US Bonds		– US Treasury yields remain low by historical standards, but look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pick-up in inflation, yields are likely to remain range bound. Our overall assessment is neutral.
Global (Ex-US) Bonds		– In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB has committed to low rates into next year, so we see limited opportunity in Europe. – Swiss bonds continue to look very overvalued and in our view they have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalize monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market. – Elsewhere we are more positive on Australian and Canadian duration on a relative basis. In our view, both economies are vulnerable to a housing market correction after very strong recent performance.
Investment Grade (IG) Corporate Debt		– Geopolitical turmoil and trade issues have spilled over into the credit markets, causing IG spreads to widen slightly in recent months. Although we do not believe that a sharp demand slowdown is imminent, we retain a neutral view on credit.
High Yield Bonds		– Current default rates in high yield are very low by historical standard. Given the relatively positive economic backdrop, we do not expect any material pick-up in US corporate debt defaults in the near-term. However, while spreads have widened in recent weeks, we do not yet view the risk/reward as attractive.
Emerging Markets Debt US dollar Local currency		– Spreads on EM debt relative to US treasuries have widened substantially in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates — sparking particular fears for EM countries with large external funding requirements. Nonetheless, we see continued strong demand for EM debt's attractive real yield on a selective basis.
Currency		– We expect global growth to re-synchronize over coming quarters, with ex-US economies showing initial signs of stabilization. We anticipate capital will flow from the US into earlier-cycle economies, especially as the USD remains somewhat expensive on a real trade-weighted basis. Elsewhere, we continue to see strong valuation support for the JPY.

Source: UBS Asset Management. As of September 30, 2018.

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