

# Macro Quarterly

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

Macroeconomic themes and tactical asset allocation opportunities

Q1 2019 | UBS Asset Management



In our view, the outlook for equities going into 2019 is positive, but the road is likely to remain bumpy.

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# Macro matters



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Since the first Macro Quarterly was published in late September, investors in risk assets have endured a chastening few months. Even with the benefit of hindsight, it is not easy to pinpoint precisely the catalysts for the shift in investor sentiment that first prompted double-digit drawdowns across global equity markets in October.

Whatever those original catalysts were, the principal drivers of investor sentiment have evolved. From the highs of early October, 10-year US Treasury yields have retraced 40 basis points with a flattening yield curve prompting plenty of investor comment and concern. Hawkish rhetoric from US Federal Reserve officials has turned notably more dovish, at least for now. Even the combative rhetoric between US and China over trade morphed, at least temporarily, into something approaching conciliatory at the G20 summit in Buenos Aires. Yet markets remain volatile.

In our view, the unbalanced drivers of global demand characterized by the US economy's stark relative strength have played a meaningful role in precipitating and sustaining that volatility. But after a period of sharp US growth outperformance, our view is that global economic growth drivers have the potential to at least partly resynchronize in 2019. How it resynchronizes is clearly critical to markets. Our expectation is that both European and Japanese industrial production will recover after material

one-off drags in 2018, that the impact of China's stimulus measures will kick in and that the boost to the US economy from fiscal stimulus will fade.

While the partial resynchronization of global growth drivers may temper to a degree the recent rise in volatility, overall we see the continued normalization of monetary policy and the gradual tightening of liquidity conditions as more powerful drivers over the medium term. Higher volatility is likely to be around for a while. In our view, the outlook for equities going into 2019 is positive, but the road is likely to remain bumpy.

In the first edition of Macro Quarterly we focused on exploring the main macroeconomic themes we see as providing the backdrop to tactical asset allocation over the medium term. Despite the ongoing near-term volatility, our conviction in the medium-term opportunity set provided by these themes remains high.

In this second issue we update the narrative and milestones for each theme, but focus instead on where we have found the most compelling dislocations on a risk-adjusted basis across asset classes within each broader theme. And given the prospect of continued volatility, we expect 2019 to offer investors able to exploit the ebb and flow of global markets plenty more opportunities as the year progresses.

<sup>1</sup> 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



Developed world consumption is likely to remain a key driver of global growth in 2019.

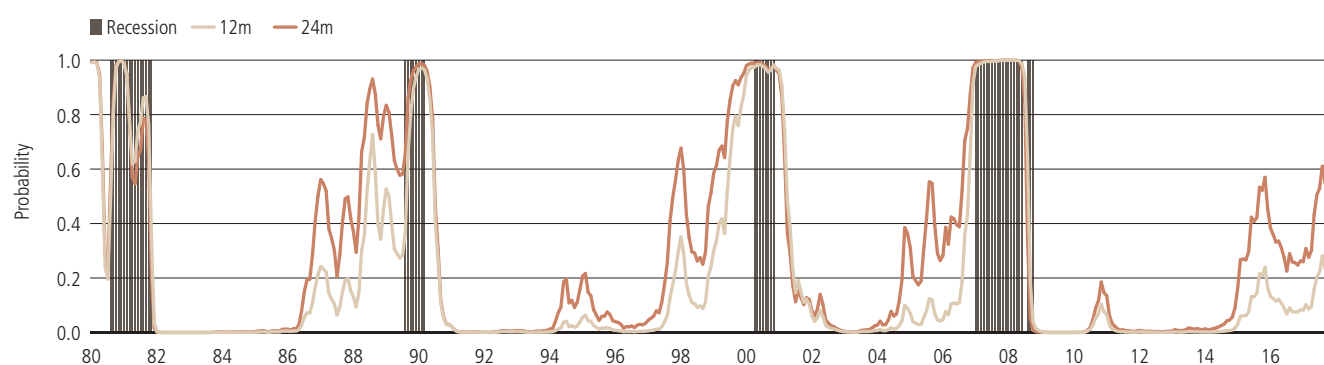
## Key messages

- The rate of acceleration in global economic growth has moderated from very strong levels in 2017 while growth rates by country and region are also more differentiated and less synchronized. But we expect global growth to be solid in 2019 and above long-term trend growth for at least the first half of the year.
- Higher trade tariffs, rising bond yields, policy uncertainty and higher geopolitical risks all raise understandable concerns about the outlook for global GDP into 2019. But without a more violent shift in expectations for any of these themes, we expect the combined impact to be moderate.
- Developed world consumption is likely to remain a key driver of global growth in 2019. Low unemployment and continued wage growth across the US, UK, Europe and Japan are the key factors here. US household leverage is not particularly elevated—suggesting that consumption growth is unlikely to demonstrate a high sensitivity to higher rates while wages are still rising and employment growth remains strong.
- And while monetary policy support to demand is likely to reduce further in 2019—it is likely to do so only gradually; financial conditions globally are not restrictive.
- Outside of the US, recent monetary, fiscal and regulatory measures in China aimed at cushioning growth are likely to work their way through in the coming months. In Europe and Japan, we expect a pick-up in manufacturing production as one-off factors that have curtailed output in 2018 fall away. In the US we expect the growth impulse to remain comfortably above trend but to moderate from the very strong momentum of early in 2018 as the fiscal stimulus starts to wane and as rate rises begin to take a gradual toll.



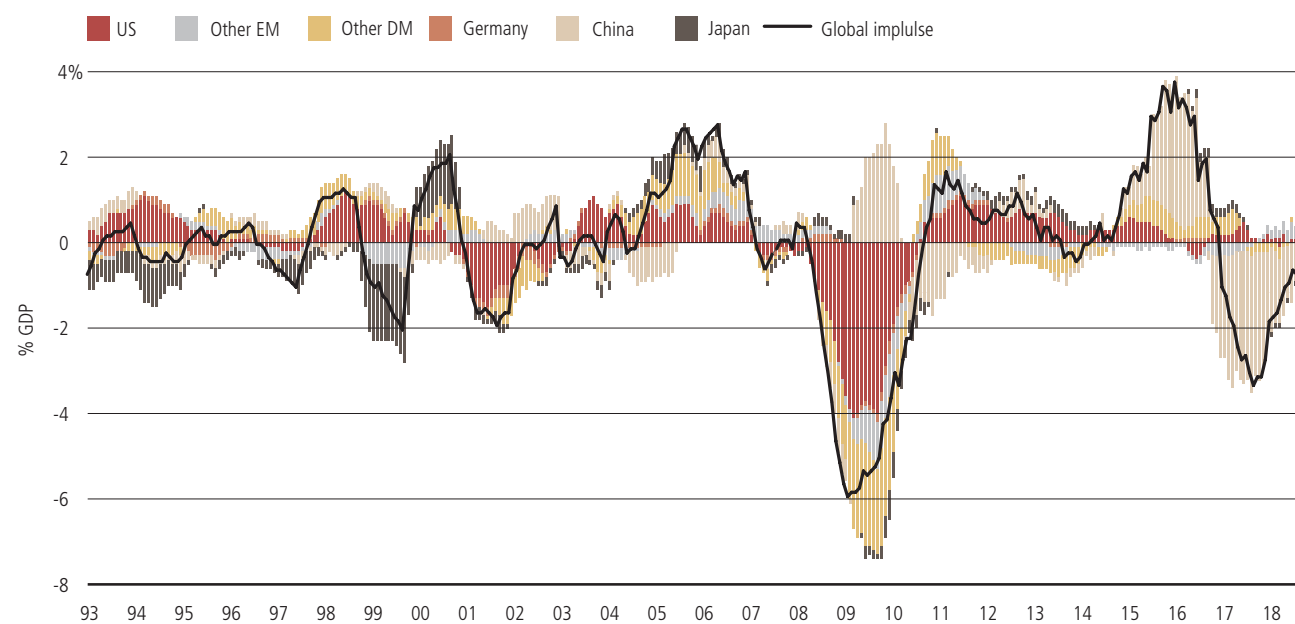
### Exhibit 1: US recession more than a year away?

UBS-AM Recession Probability Model (12m, 24m)



Source: UBS Asset Management, Macrobond as at November 2018

### Exhibit 2: Contributions to Global Credit Impulse (market GDP weighted)



Source: UBS Investment Bank as at Q3 2018

### Exhibit 3: Milestones

| Theme supportive  | Theme challenges   |
|---|--|
| Business investment continues to rise, supporting productivity                  | Global PMIs fail to stabilize  |
| Recession indicator remains contained   | US recession tracker probabilities rise  |
| Labor markets continue to strengthen, boosting consumer confidence and spending | Tariffs meaningfully disrupt supply chains, weigh on business confidence and slow investment |
| Fiscal policy supportive in countries/regions with low public debt              | Widening of credit spreads   |

### Exhibit 4: Asset class implications

| Asset class  | View   | Overall signal   | Theme trades  |
|--------------|--|--|---|
| Equities     | <ul style="list-style-type: none"> <li>While risk-adjusted returns are strongest when growth is accelerating, equities may post positive gains when growth is stable above trend.</li> </ul>   | Neutral to positive<br>More selective on regional exposure | L MSCI World<br>L EM vs US<br>L EMU Banks vs EMU<br>L EAFE vs US<br>L FTSE MIB vs Eurostoxx 50<br>L China H vs Taiwan |
| Fixed income | <ul style="list-style-type: none"> <li>Above trend growth amid closing or closed output gaps may put upward pressure on inflation. This suggests an underweight to duration.</li> <li>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.</li> </ul>                        | Negative   | S Global duration<br>L US Breakeven<br>L Asian bonds Hard Currency  |
| Currencies   | <ul style="list-style-type: none"> <li>In a vacuum, above-trend global growth is consistent with outperforming high beta and EM FX.</li> <li>But with much of the growth impetus coming from the US, the USD has been stronger against EM and currencies with large external liabilities.</li> <li>Should ex-US growth stabilize as we expect, the USD is likely to soften. Non-USD regions that are earlier in their respective business cycles will attract inflows, supporting their currencies.</li> </ul> |  | S USDMXN<br>L EURCHF<br>L European FX vs USD  |
| Utility      | <ul style="list-style-type: none"> <li>If the US business cycle turns sooner than we expect, credit is likely to underperform. Long equity exposure can be hedged with an underweight to credit.</li> </ul>  |  | S US 5y HY CDS  |

We see the Fed pausing in 2019 as the growth trajectory moderates.

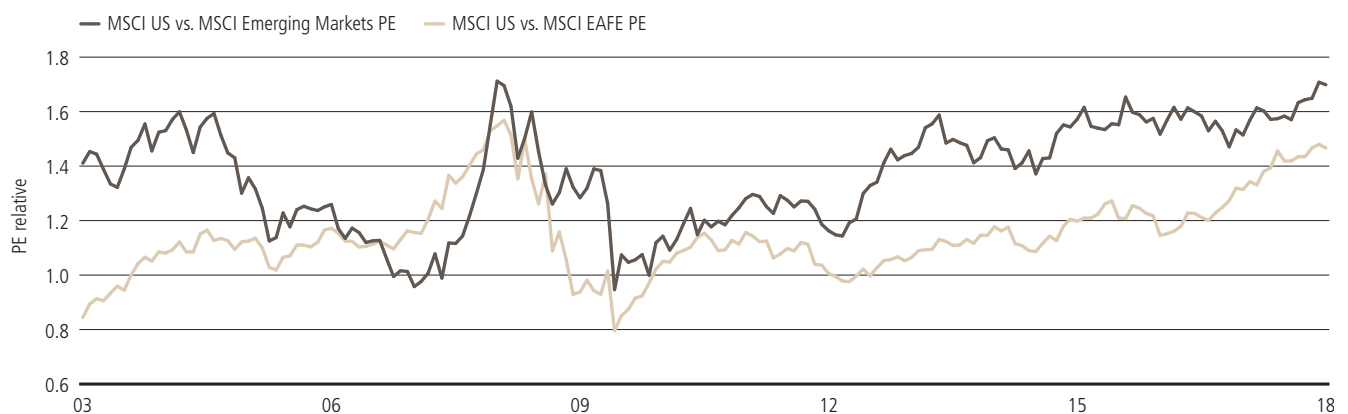


## Theme case study: Long EM vs. S&P 500

- We believe that emerging market equities are attractively valued relative to their own history on a number of measures, and on a relative basis against US equities in particular. We do not believe such an extreme is warranted.
- Key to the outlook for emerging market asset classes in 2019 is the outlook for US rates and for the USD. Growth divergence has put stresses on Emerging Market economies and asset classes in 2018. But we see the potential for global growth drivers to at least partly resynchronize in 2019. As the impetus from fiscal stimulus starts to fade in the US and as the lagged effect of rate hikes-to date start to drag on growth, we see the Fed pausing in 2019 as the growth trajectory moderates. This is likely to put downward pressure on US rate expectations and the USD – and support EM equities.
- We expect solid earnings growth and continued share buy backs to support US equities. But earnings expectations are, in our view, at least partly vulnerable to margin compression. Wages are rising and debt servicing costs are likely to follow interest rates higher at a time when the overall growth impulse may moderate in 2019. There are also growing regulatory risks to the US technology heavyweights after a number of years of strong outperformance.
- In EM, we see the reverse scenario. After a difficult year, investor expectations for profits are low. We expect the impact of China's monetary, fiscal and regulatory stimulus to kick through in 2019 – supporting both China and wider EM demand in the process. In our view the structural demographic story is far from over and continues to support long-term growth potential that is significantly greater than the outlook for the developed world.
- Given the improvement in fundamentals since 2013's Taper Tantrum, we believe concerns about a full blown emerging market crisis that began in August with the very sharp depreciation of the Turkish lira are overblown.

### Exhibit 5: US Valuations look stretched relative to the RoW

MSCI US PE relative to MSCI EM, MSCI EAFE



Source: UBS Asset Management, Refinitiv November 2018

Note: This is not investment advice or a recommendation to buy or sell any securities.



# Higher volatility



The slow removal of policy accommodation is still likely to result in a higher volatility regime.

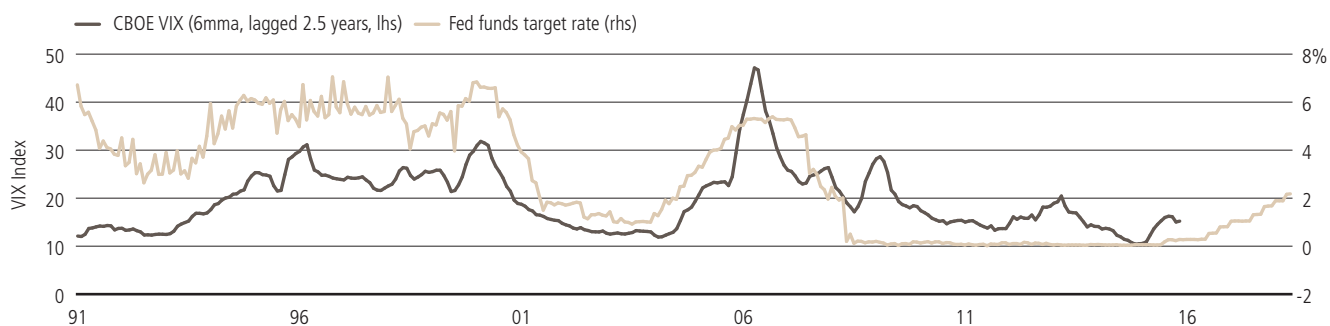
## Key messages

- As the US cycle matures, the range of potential growth, inflation and interest rate outcomes is broadening from the very narrow range investors have been used to. Moreover, the longer the tightening cycle goes on the more investors question the ability of the Fed to avoid a recession. This uncertainty will likely lead to higher volatility.
- While we believe that monetary policy conditions globally will be normalized only gradually, the slow removal of policy accommodation is still likely to result in a higher overall volatility regime across asset classes.
- Historically, the initiation of a Fed tightening cycle leads a rise in volatility by around 2 to 2.5 years.
- Higher interest rates increase the discount rate and risk premia applied to risk assets—resulting in lower fair values using discounted cashflow methodologies. Higher rates also pressure more highly leveraged companies and economies.
- Nonetheless, risk-adjusted returns for major asset classes tend to be positive, but lower as the economy moves late cycle and volatility rises.
- Imbalanced growth can lead to a stronger USD, which tightens financial conditions in the US and sparks higher volatility in emerging markets.
- Growing geopolitical risks, particularly on the trade front, should add to volatility. Political risk is rising in Europe with populists challenging EU fiscal rules.



### Exhibit 1: Relationship between higher rates and higher volatility is clear

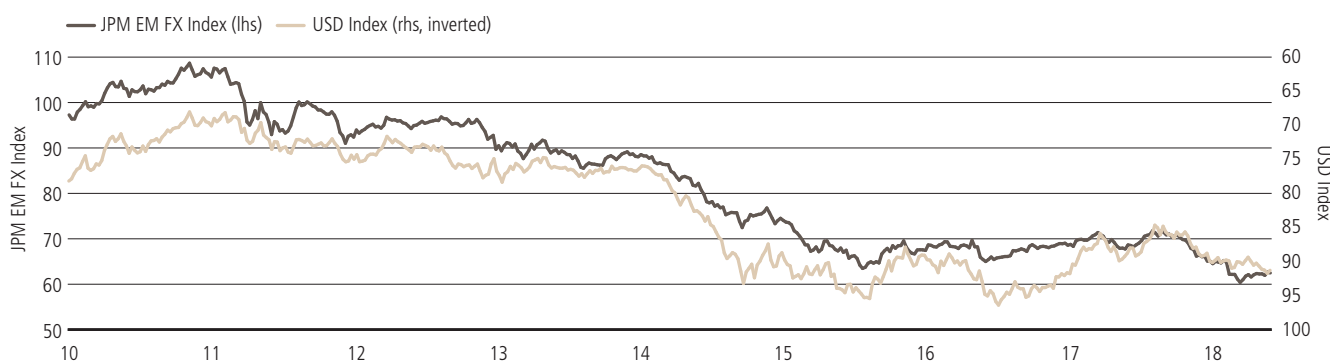
Fed Funds Rate v CBOE VIX (6mma, lagged 2.5yrs) Oct 1991 to Oct 2018



Source: UBS Asset Management, Refinitiv November 2018

### Exhibit 2: USD up, EM FX down

USD Index (RHS, Inverted) v JP Morgan EM FX Index



Source: UBS Asset Management, Refinitiv Q4 2018

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**Exhibit 3: Milestones**

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

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**Exhibit 4: Asset class implications**

| Asset class  | View  | Overall signal | Theme trades               |
|--------------|---|----------------|----------------------------|
| Equities     | <ul style="list-style-type: none"><li>– 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.</li><li>– There is a long history of energy performing as the economy moves into late cycle. Rising geopolitical risks in the Middle East are hedged with energy exposure.</li></ul> | Neutral        | L MSCI USA Energy vs. MSCI |
| Fixed income | <ul style="list-style-type: none"><li>– We are short duration as central banks gradually remove accommodation.</li><li>– If inflation rises significantly, both equities and fixed income could be challenged.</li><li>– 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.</li></ul>                                | Neutral        | S US 5yr HY CDS            |
| Currencies   | <ul style="list-style-type: none"><li>– We are short various high beta and commodity currencies to hedge against a volatility pick up.</li><li>– Safe haven currencies, such as USD, JPY, and CHF should outperform in more volatile environments.</li></ul>  |                | S USDJPY<br>L JPYKRW       |

The combination of higher debt servicing costs and elevated leverage leaves US credit vulnerable.

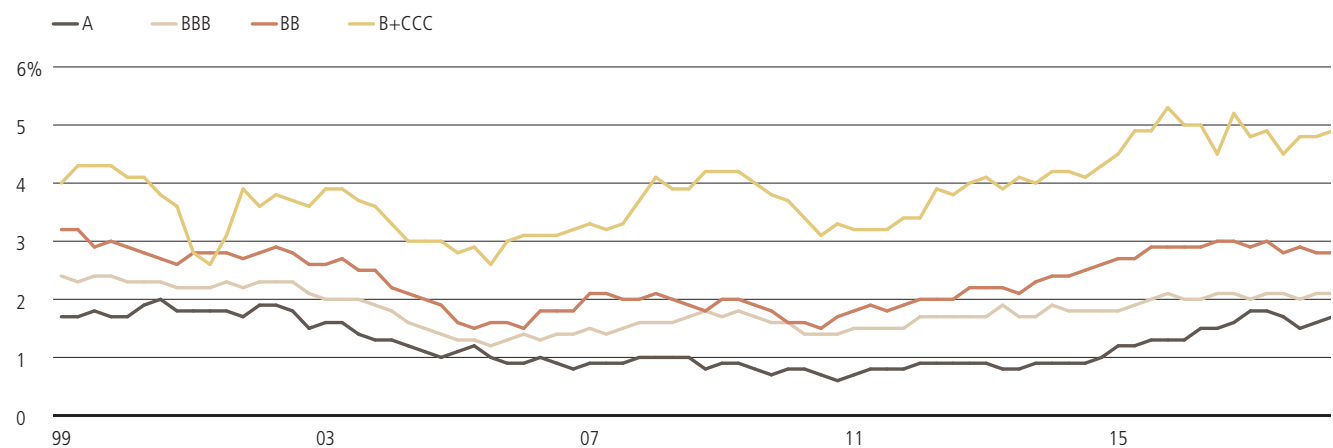


## Theme case study: Short US High Yield

- Our view on US High Yield has been negative for the majority of 2018. We do not expect a significant increase in defaults in the short-term. Overall, US corporates appear able to manage their debt burden.
- But in our view, compressed US High Yield spreads over Treasuries significantly underprice potential risks to the lowest quality corporate credit as US rates rise and as the US economic cycle matures.
- US non-financial corporate debt is high. When interest rates were low, overall interest cover was not a major issue. The combination of higher debt servicing costs as rates rise and elevated leverage at a time when we expect the US growth and earnings backdrop to moderate leaves credit vulnerable to volatility spikes and presents, in our view, an asymmetric risk profile.
- We also see High Yield as vulnerable to additional global risks including a more pronounced economic slowdown in China (not our base case), higher equity market volatility and a further increase in protectionist trade policies.
- From a broader multi-asset perspective, we see the normalization of US monetary policy via higher short-term rates and the reversal of Quantitative Easing putting upward pressure on risk premia across asset classes. That includes US High Yield.
- In the context of our positive stance on global equities, we see short US High Yield as an effective hedge against a more widespread increase in investor risk aversion. In our view, more of the potential risks to risk assets are priced into equities than in US High Yield.

### Exhibit 5: Rising US corporate leverage

US corporates: median leverage by credit rating Q1 1999 to Q2 2018



Source: UBS, Worldscope, Bloomberg, Q3 2018

Note: This is not investment advice or a recommendation to buy or sell any securities.

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# Moderately higher inflation and bond yields



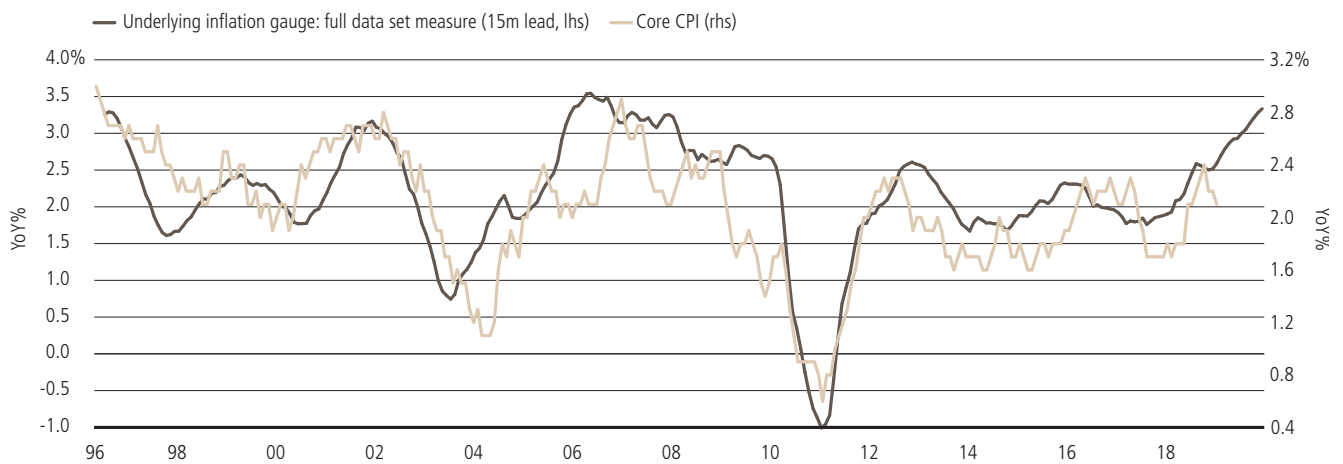
The deflationary trend associated with globalization appears to have reached a peak.

## Key messages

- Both core inflation and nominal government bond yields in major developed countries are still at low levels in this cycle. Amidst increasing global growth concerns, the most recent direction of benchmark developed world government bond yields has been lower. But we believe yields will move gradually higher over the medium-term.
- In many regions and countries, the closure of output gaps is allowing central banks to gradually withdraw monetary policy accommodation leading to a higher interest rate term structure.
- The US economy has led the policy cycle where pro-cyclical fiscal stimulus has further supported growth in employment and wages. In our view this will lift inflation and nominal bond yields. But the move is likely to be gradual.
- As central banks like the ECB and BoJ move towards tightening, this will put upward pressure on global yields as investors adjust portfolios.
- Meanwhile, the deflationary trend associated with globalization appears to have reached a peak, at least for now, as the rise of populism and protectionism is leading to higher prices via trade tariffs.
- Nonetheless, we believe that the inflationary pressures that are emerging are gradual and mostly cyclical and see a sharp upward move in either core inflation or nominal bond yields as unlikely in the context of longer-term structural themes weighing on inflation including aging populations and new technology.

### Exhibit 1: Broad Fed inflation measure points to upside for official US CPI

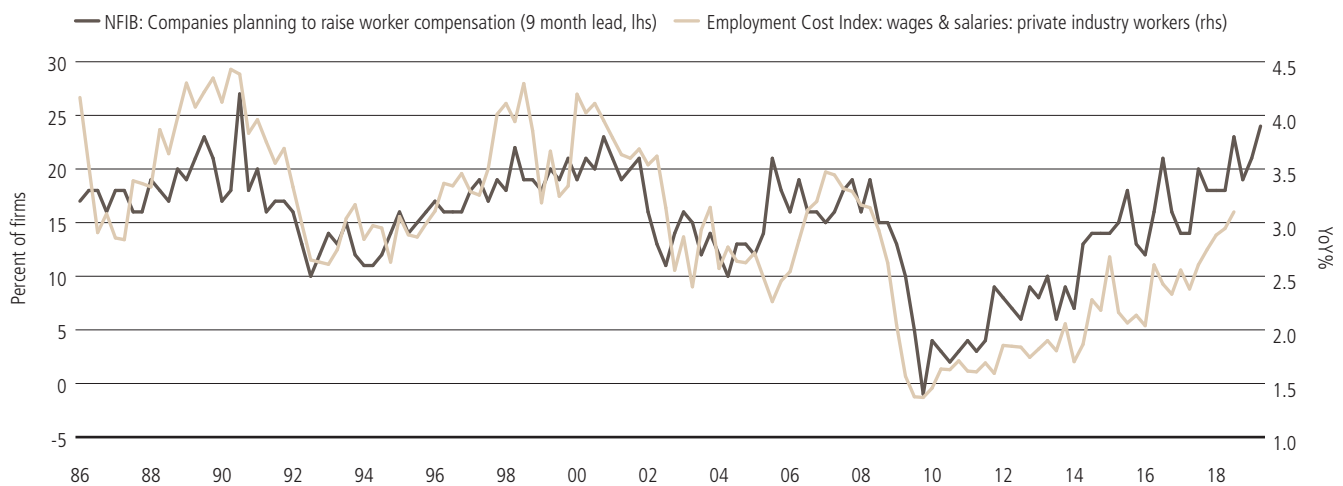
US underlying inflation gauge full data set (lhs, 15m lead) v US CPI (rhs), YoY%



Source: UBS Asset Management, Deutsche Bank Q4, 2018

### Exhibit 2: US wages and inflation likely to continue moving higher

US companies planning to raise wages (lhs, 9m lead) v Employment Cost Index (rhs)



Source: Deutsche Bank Q4 2018



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**Exhibit 3: Milestones**

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

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**Exhibit 4: Asset class implications**

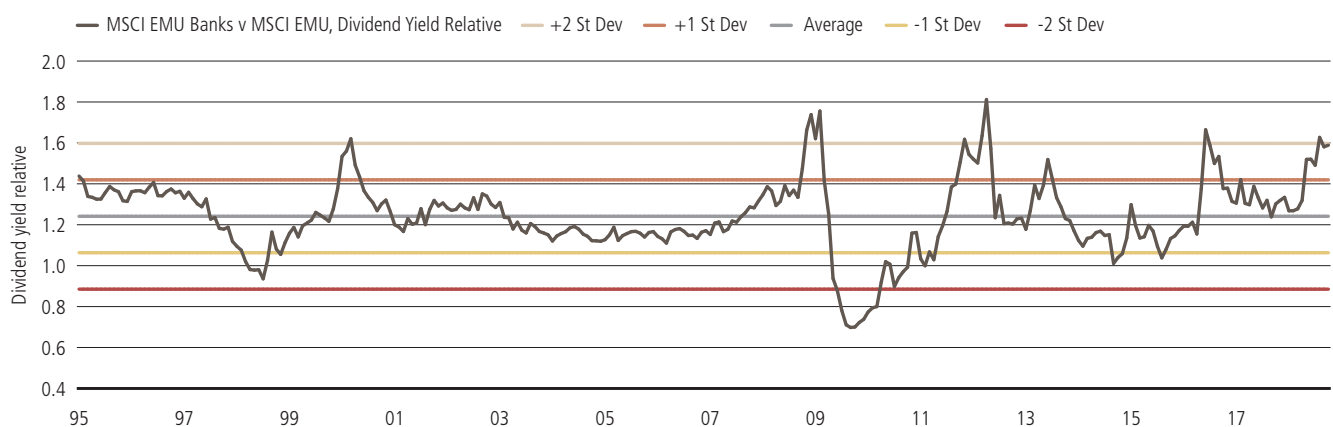
| Asset class  | View   | Overall signal      | Theme trades   |
|--------------|--|---------------------|--|
| Equities     | <ul style="list-style-type: none"><li>– Equities and commodities tend to have positive returns in a late cycle environment.</li><li>– Higher yields generally correlate with outperformance of financials.</li><li>– Exposure to infrastructure and alternative assets that benefit from higher inflation.</li></ul>   | Neutral to positive | L MSCI USA Energy vs. MSCI USA<br>L EMU Banks v EMU Equity<br>L S&P vs OMX<br>L FTSE MIB vs Eurostoxx 50<br>L EAFE vs US |
| Fixed income | <ul style="list-style-type: none"><li>– Upward pressure on inflation suggests an underweight to duration and exposure to floating rate securities.</li><li>– Exposure to inflation indexed securities and derivatives.</li></ul>   | Negative            | S Global duration<br>L US Breakeven  |
| Currencies   | <ul style="list-style-type: none"><li>– Reflation theme is consistent with outperformance of high beta and EM FX but we want to avoid countries with high external liabilities and current account deficits.</li><li>– A higher yield environment typically encourages investors in low interest rate regions (like Switzerland) to look abroad for returns.</li></ul> |                     | L EURCHF   |
| Utility      | <ul style="list-style-type: none"><li>– Should reflationary dynamics falter, US bond yields are likely to decline as will other non-USD bloc markets.</li><li>– USDJPY will likely move lower if inflation and yields falter.</li></ul>  |                     | S USDJPY   |

Eurozone banks look extremely attractively valued in a long-term context on a whole host of measures.

## Theme case study: Short global duration/ L EMU Banks v EMU Equity

- We believe that inflation and bond yields in major developed countries will generally shift higher across asset classes.
- The most direct play on this theme is a short global duration trade. In our view, the pieces are beginning to fall into place for a moderate increase in inflation and a gradual shift higher in nominal bond yields after a protracted period of very low interest rates thanks to ultra loose monetary policy.
- Ultra accommodative policy is being removed and against this backdrop, term premia is also expected to rise. Meanwhile, labor markets in the developed world are tightening and wage growth is beginning to accelerate from low levels. We expect this to continue and to be passed on via higher prices. Alongside closing output gaps, we see inflation ticking higher. In our view, this may mean that central banks such as the BoJ and ECB may begin to tighten sooner than investors expect.
- Banks in both Europe and Japan are likely to be among the biggest beneficiaries of these trends – having suffered with low interest rates and flat yield curves for most of the post financial crisis period. While European economic data has generally disappointed, we believe the cycle has further to run and that bad debts are unlikely to increase substantially without some sort of exogenous shock.
- Against this backdrop, Eurozone banks look extremely attractively valued in a long-term context on a whole host of measures. While some of the valuation discount to history fairly reflects banks' structurally lower ROEs in the post-financial crisis world of higher capital ratios and increased regulatory costs, and the geopolitical risks of Brexit and Italy, there is very little priced in for an improving economic backdrop, a steeper yield curve and higher rates. In our view, the risk/reward is therefore attractive.

**Exhibit 5: MSCI EMU Banks v MSCI EMU, Dividend Yield Relative**



Source: UBS Asset Management, Refinitiv November 2018

Note: This is not investment advice or a recommendation to buy or sell any securities.



# Geopolitics and protectionism



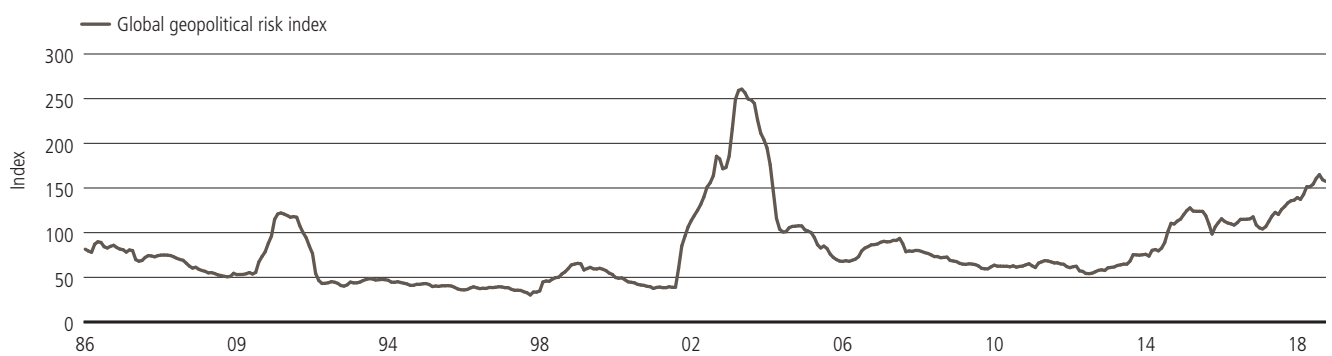
We do not believe that the issues at the heart of the US/China dispute can be resolved quickly.

## Key messages

- Attitudes towards globalization have turned negative in the developed world. Populist parties have also significantly increased their share of the vote in recent elections across Europe.
- We believe that the US/China trade dispute, the source of most of investors' concerns about protectionism, is as much about technology security as it is about tariffs and the US trade deficit. While a more conciliatory tone may appear to have emerged in the trade truce agreed at the recent G20 summit, we do not believe that the issues at the heart of the dispute—US concerns about China's attitudes to intellectual property, technology transfer, and desire to develop its own high tech industries to compete with the US—can be resolved quickly.
- There has been a significant global deflationary trend associated with globalization. The deflationary trend associated with globalization appears to have reached a peak at least for now as the rise of populism and protectionism is leading to the imposition of trade tariffs and restriction of labor mobility.
- Populists are pushing against the European institutional framework on fiscal rules and immigration. At the very least, this is likely to slow reform efforts in the EU.

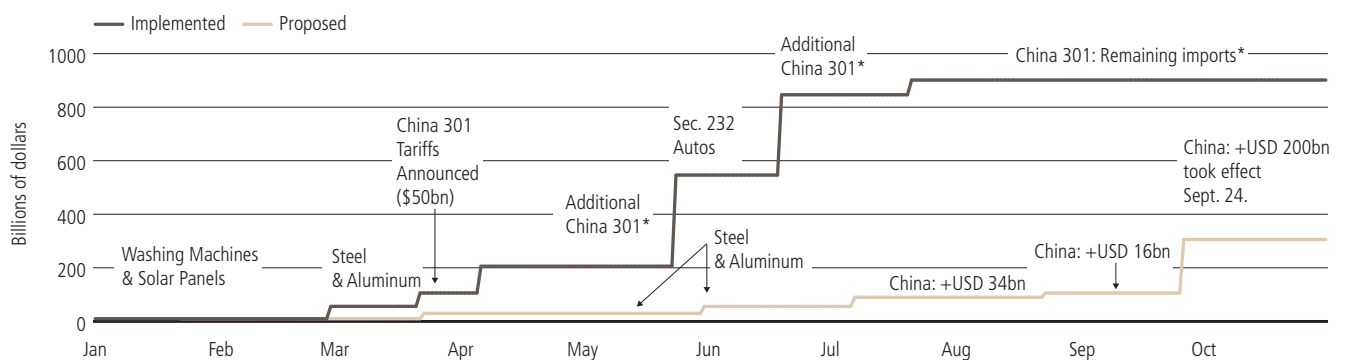


**Exhibit 1: Global geopolitical risk index—Jan 1986-Oct 2018**



Source: Caldara, Dario and Matteo Iacoviello, Board of Governors Federal Reserve Board

**Exhibit 2: US Imports Subject to Proposed vs. Implemented Tariffs**



Source: USTR, Goldman Sachs Sept. 2018

\*In April, the White House proposed tariffs on additional \$100bn in imports in response to China's retaliation. This supplemental proposal was increased to \$400bn on June 18 and to all remaining imports on July 20.

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**Exhibit 3: Milestones**

| Theme supportive  | Theme challenges  |
|---|---|
| Further escalation of anti-trade measures between the US and its allies vs. China.<br>Broadening of anti-trade measures beyond goods towards investment and IT restrictions | Comprehensive US-China trade deal, reversal of recent successes for populist parties across developed world |
| Trump administration places tariffs on auto imports   | Trump administration backs away from auto tariffs; broader trade agreements achieved with US allies         |
| Populists gain enough share of seats in European Parliament election to influence fiscal/immigration policy   | Pro-EU politicians maintain sufficient power to maintain existing policies and continue with EU reform      |

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**Exhibit 4: Asset class implications**

| Asset class  | View   | Overall signal | Theme trades             |
|--------------|--|----------------|--------------------------|
| Equities     | <ul style="list-style-type: none"><li>– Both trade and immigration restrictions tend to reduce growth and profits via increased costs.</li><li>– However, exporters will be hurt more than companies with mostly domestic revenues.</li><li>– Cyclical would underperform defensives.</li><li>– Some regions may be more susceptible to rising trade tensions than is currently priced in.</li></ul> | Negative       | L China H vs MSCI Taiwan |
| Fixed income | <ul style="list-style-type: none"><li>– Upward pressure on inflation suggests an underweight to duration.</li><li>– Downward pressure on growth is negative for credit spreads.</li></ul>  | Neutral        | S US 5yr HY CDS          |
| Currencies   | <ul style="list-style-type: none"><li>– EM currencies are high beta to both global growth and trade.</li><li>– Safe haven currencies, such as USD, JPY, and CHF should outperform regardless of the nature of a geopolitical shock.</li></ul>  |                | S USDJPY<br>L JPYKRW     |
| Utility      | <ul style="list-style-type: none"><li>– A cooling of tensions on trade and immigration could be supportive of MXN.</li></ul>   |                | S USDMXN                 |

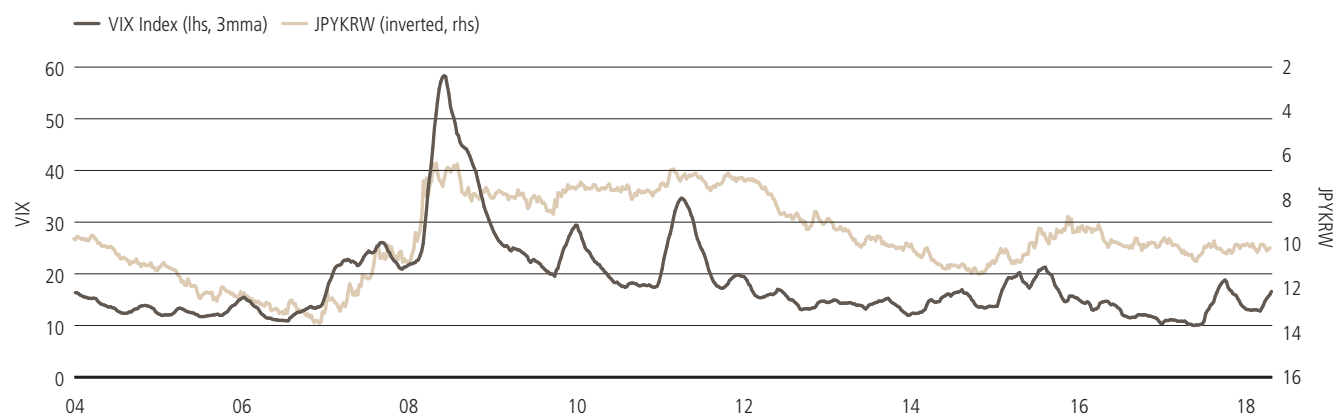
The Japanese Yen continues to demonstrate strong safe haven characteristics in global ‘risk off’ environments.

## Theme case study: L JPYKRW

- We believe that economic momentum is building in Japan and that the tightness of the Japanese labor market may lead to signs of wage growth that could prompt the market to price an end to the BoJ's extraordinarily easy monetary policy.
- In Korea, recent economic data has been broadly disappointing, with Q3 GDP missing estimates amidst falling capital formation and weak consumption.
- The Korean economy enjoyed a substantial boost from strong growth in semiconductor exports in 2018—a boost that is likely to fade as 2019 progresses. Given the importance of semiconductors to overall demand, Korea's economy and currency therefore remains particularly vulnerable to any slowdown in the global IT industry.
- But this trade is also very much a play on the risk characteristics of each currency. The Japanese Yen continues to demonstrate strong safe haven characteristics in global 'risk off' environments and particularly those related to geopolitics and protectionism.
- As a major exporting manufacturer, South Korea is exposed to any disruption in global supply chains and in particular to the current US/China trade dispute. The Korean Won is therefore exposed to any escalation in global trade tensions both directly, via its own trade relationship with the US, and indirectly via the US trade dispute with China.
- Meanwhile, the combative rhetoric between the US and North Korea has thankfully evolved into something more conciliatory over the past year including the historical meeting between the two leaders in Singapore. But Korea is clearly still exposed to any change in this fragile détente.
- In our view, the trade has strong risk-off characteristics and may perform well if trade tensions increase and if geopolitical tensions on the Korean peninsula escalate.

### Exhibit 5: JPY as 'risk off' currency

VIX Index (lhs, 3mma) v JPYKRW (inverted, rhs)

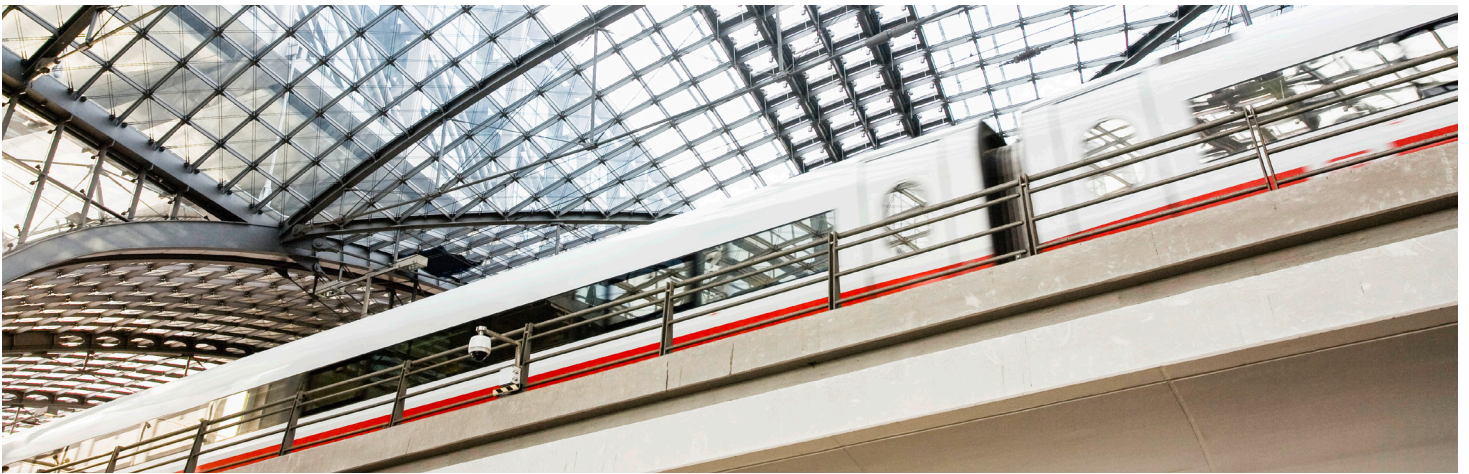


Source: UBS Asset Management, Refinitiv as at Q4 2018

Note: This is not investment advice or a recommendation to buy or sell any securities.



# The monetary policy balancing act



We see the monetary policy backdrop globally as offering a potentially rich source of tactical asset allocation opportunities.

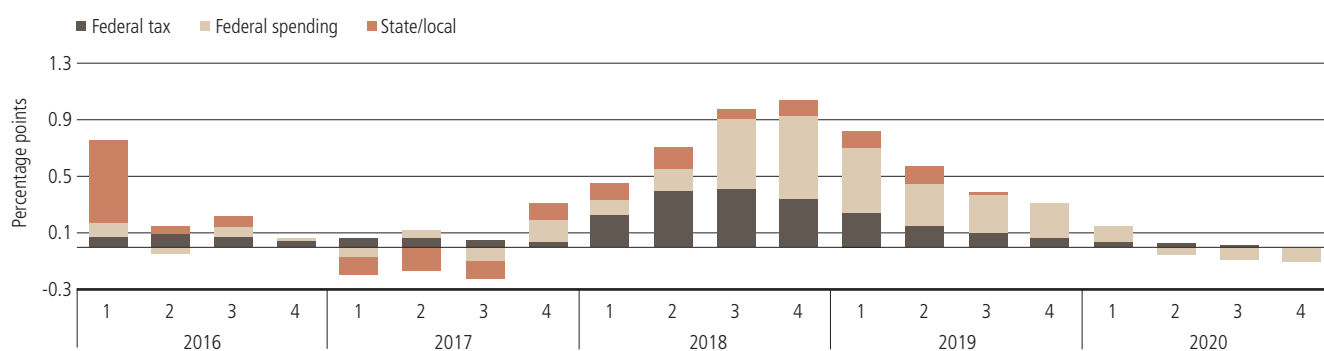
## Key messages

- After such a protracted period of ultra-loose monetary in the developed world and as output gaps close and wage growth accelerates, the direction of monetary policy travel in the US, Japan and in the Eurozone may be clear, but the speed of travel is not.
- As markets underprice growth prospects and potential policy tightening in some countries and overprice inflationary pressures and potential tightening in others, we see the monetary policy backdrop globally as offering a potentially rich source of tactical asset allocation opportunities across asset classes for a considerable period.
- We expect that recent Chinese monetary, fiscal and regulatory stimulus to cushion growth will kick-in in 2019—and that production in the important autos sector in Europe and Japan will recover strongly from one-off factors that adversely hit output in 2018.
- In both Europe and Japan, we also believe that gradual capacity constraints will continue to push core inflation higher. In both cases we see a risk the central bank moves sooner than is reflected in markets.
- In the US, we expect the boost to demand growth provided by the fiscal stimulus to diminish as 2019 progresses. The Fed is also well aware of the long lags between policy moves and quantifiable impact on demand. There is a risk that markets on a cross-asset basis are not reflecting what may be a meaningful shift in the Fed's reaction function.



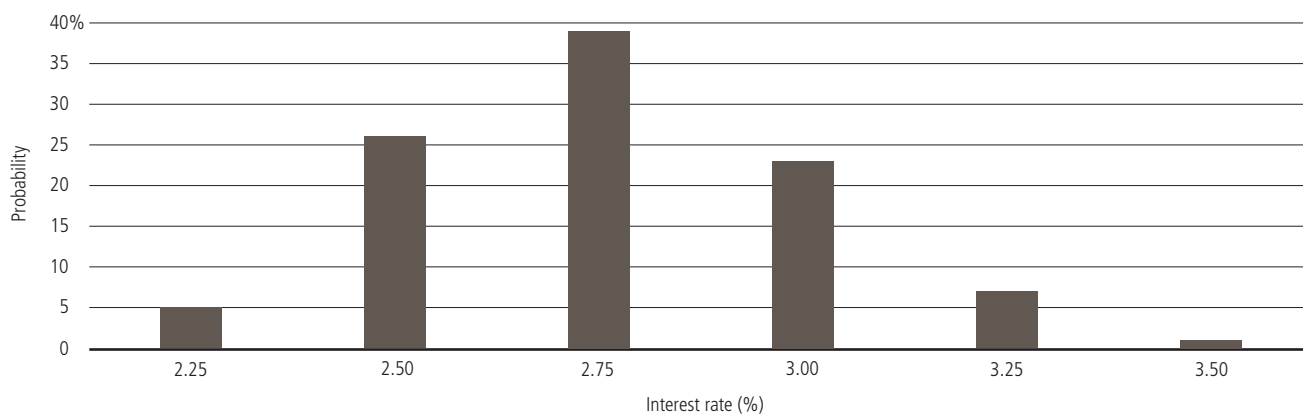
### Exhibit 1: Peak impact of fiscal policy on US growth already reached

Effect of US fiscal policy on US Real GDP Growth



Source: UBS Asset Management, Goldman Sachs Investment Research Q4, 2018

### Exhibit 2: Market implied Fed Funds rate December 2019 as at end November 2018



Source: UBS Asset Management, Refinitiv November, 2018

### Exhibit 3: Milestones

| Theme supportive (Convergence)                                     | Theme challenges (Ongoing divergence)                       |
|--|---|
| Ex-US growth and core inflation pick up                            | US growth and inflation accelerate further                  |
| The Fed signals a pause as it approaches estimates of R*           | Fed hikes faster and by more than implied by market pricing |
| China significantly expands fiscal policy, supporting ex-US growth | PBOC allows interest rate spread to US to narrow further    |

### Exhibit 4: Asset class implications

| Asset class  | View   | Overall signal | Theme trades   |
|--------------|--|----------------|--|
| Equities     | <ul style="list-style-type: none"> <li>Over time, stronger Euro growth, receding political concerns will lead to higher European yields supporting European banks.</li> <li>Rebalancing of global growth, Fed pause is negative for USD and positive for ex-US equities, particularly EM.</li> </ul>   | Neutral        | L EMU Banks v EMU Equity<br>L EM v S&P 500               |
| Fixed income | <ul style="list-style-type: none"> <li>As the US is the global monetary anchor, the removal of US policy accommodation should put upward pressure on bond yields globally.</li> <li>Accommodative monetary policy in Europe and Japan should limit how much yields can rise in the US in the short-term.</li> <li>Tighter Fed policy is consistent with late cycle behavior and a short HY position.</li> </ul>  | Negative       | S US 5y HY CDS<br>L CAD 10Y vs US                        |
| Currencies   | <ul style="list-style-type: none"> <li>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.</li> <li>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 Canada and our short USD positions against countries where the probability of central bank hiking is underpriced.</li> </ul> |                | S AUDUSD<br>L USDCAD<br>L EURCHF<br>L European FX vs USD |

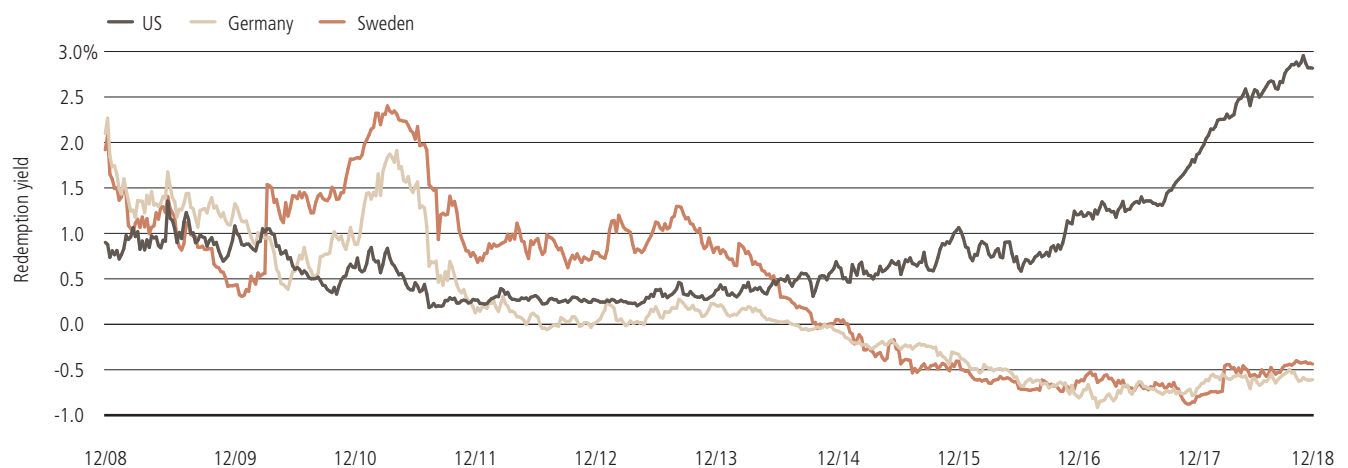
Monetary policy is extremely easy considering this economic backdrop, particularly in the Eurozone and Sweden where rates remain negative.

## Theme case study: Long European FX vs. USD

- We are long a basket of euros, Norwegian krone and Swedish krona against the USD on the view that monetary policies will at least partly converge over the course of 2019.
- With the US much later in its economic cycle and the Federal Reserve's interest rate tightening cycle similarly well advanced, a pause in Fed hiking is likely in 2019 in our view. Indeed, the recent tightening of financial conditions and a moderating fiscal impulse is likely to lead to a moderation of US growth.
- While European economies have lost some demand momentum of late, in part due to one-off factors, growth is still trending above potential and labor markets are tightening. Wage growth is rising but from low levels and only gradually. Nonetheless, monetary policy is extremely easy considering this economic backdrop, particularly in the Eurozone and Sweden where rates remain negative.
- Markets currently price the ECB to deliver its first hike well into 2020; in our view, there is plenty of room for repricing a more hawkish ECB if European growth stabilizes as we expect.
- We believe that all three European currencies are undervalued against USD on several measures including purchasing power parity and behavior equilibrium exchange rate (BEER) models.

### Exhibit 5: Rate differentials peaking?

Benchmark 2yr yields US, Germany and Sweden



Source: UBS Asset Management, Refinitiv Q4 2018

Note: This is not investment advice or a recommendation to buy or sell any securities.










# Trades by theme

Our favored trade expressions  
of each macroeconomic theme

## Exhibit 1: Trade summary by theme

| Theme  | A/C | Trade                          |
|--|-----|--------------------------------|
| <br>Higher volatility                             | EQ  | L MSCI USA Energy v MSCI USA   |
|  | EQ  | L S&P vs OMX                   |
|  | FI  | S US 5y High Yield CDS         |
|  | FX  | S USDJPY                       |
|  | FX  | L JPYKRW                       |
| <br>Global growth steadies above trend            | EQ  | L MSCI World                   |
|  | EQ  | L EAFE vs US                   |
|  | EQ  | L Emerging Markets vs US       |
|  | EQ  | L China H vs Taiwan            |
|  | EQ  | L FTSE MIB vs Eurostoxx 50     |
|  | EQ  | L EMU Banks vs EMU             |
|  | FI  | L Asian Bonds                  |
|  | FX  | S USDMXN                       |
|  | FX  | L European FX vs USD           |
|  | FX  | L EURCHF                       |
| <br>Moderately higher bond yields and inflation | EQ  | L MSCI USA Energy vs. MSCI USA |
|  | EQ  | L EMU Banks v EMU Equity       |
|  | EQ  | L S&P vs OMX                   |
|  | EQ  | L FTSE MIB vs Eurostoxx 50     |
|  | EQ  | L EAFE vs US                   |
|  | FI  | S Global duration              |
|  | FI  | L US Breakeven                 |
|  | FX  | S NZDUSD                       |
|  | FX  | S CADUSD                       |
|  | FX  | S AUDUSD                       |
|  | FX  | L EURCHF                       |
| <br>The monetary policy balancing act           | EQ  | L EMU Banks vs EMU             |
|  | EQ  | L Emerging Markets vs US       |
|  | FI  | L CAD 10Y vs US 10Y            |
|  | FX  | L EURCHF                       |
|  | FX  | S AUDUSD                       |
|  | FX  | L USDCAD                       |
|  | FX  | L European FX vs USD           |
| <br>Geopolitics and protectionism               | FX  | S NZDUSD                       |
|  | FI  | S US 5yr HY CDS                |
|  | EQ  | L MSCI USA Energy vs MSCI USA  |
|  | EQ  | L S&P vs OMX                   |
|  | FX  | S USDJPY                       |
|  | FX  | L JPYKRW                       |

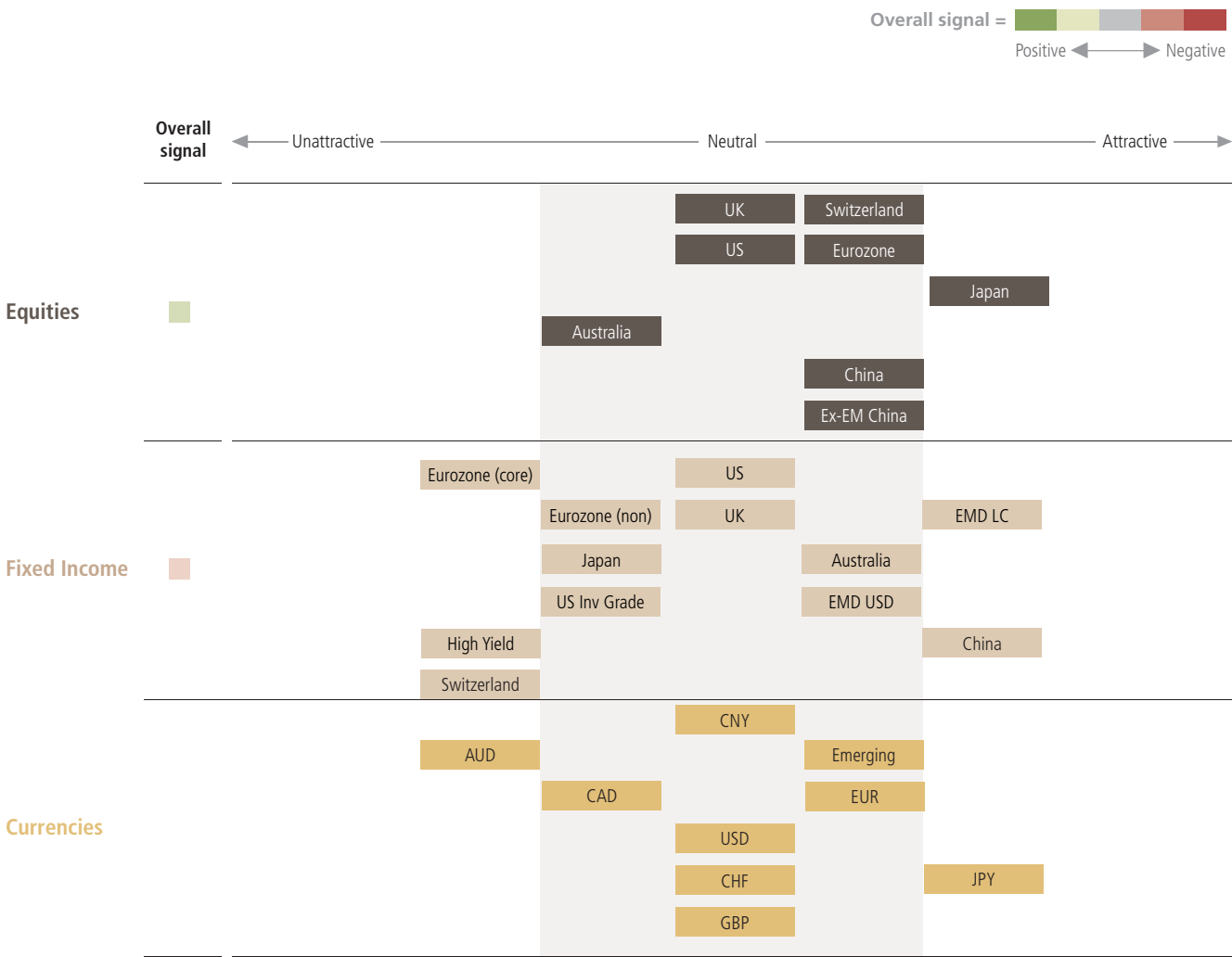
Note: Trade ideas are subject to change without notice. Inclusion in Multi Asset portfolios dependent on specific portfolio return objectives and risk parameters.





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 November 30, 2018.



Source: UBS Asset Management Investment Solutions Asset Allocation team as at November 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  |
|---|---|---|
| <b>US Equities</b>                                    |    | <ul style="list-style-type: none"> <li>US equities remain supported by strong corporate earnings growth, peak margins, solid manufacturing activity and increasing capital returns to shareholders. But the recent earnings season exposed vulnerabilities in some momentum sectors and illustrates how difficult a return towards more normal growth expectations can be—especially after a period of exceptionally supportive fiscal and monetary policy. We do not expect current headwinds on the IT sector to abate quickly given the present political and regulatory environment.</li> <li>The recent derating of equities has created value assuming this above-trend growth phase of the economic cycle still has legs; we think it does.</li> </ul>   |
| <b>Global (Ex-US) Equities</b>                        |    | <ul style="list-style-type: none"> <li>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 relationship between Italy's populist government and the European Commission. Despite these short-term headwinds, our longer-term base case remains positive, supported by decent demand growth, and the potential support to earnings from balance sheet optimization.</li> <li>In Japan, diminished political uncertainties and on-going structural reforms support a higher price multiples while building economic momentum suggests the outlook for profits growth is stronger than markets are currently discounting.</li> </ul>   |
| <b>Emerging Markets (EM) Equities including China</b> |    | <ul style="list-style-type: none"> <li>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.</li> <li>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.</li> <li>We remain broadly positive on China. Any broadening of the current trade standoff 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 provide monetary, fiscal and regulatory support 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.</li> </ul> |
| <b>US Bonds</b>                                       |  | <ul style="list-style-type: none"> <li>After recent repricing of the Fed's outlook, US Treasury yields are now much closer to our estimate of fair value. 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 or term premium, yields are likely to remain range bound. Our overall assessment is neutral.</li> </ul>   |
| <b>Global (Ex-US) Bonds</b>                           |  | <ul style="list-style-type: none"> <li>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.</li> <li>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 normalise monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market.</li> <li>Elsewhere we are more positive on Australian duration on a relative basis. We see the Reserve Bank of Australia taking a cautious approach to policy given elevated household leverage and low inflation.</li> </ul>  |
| <b>Investment Grade (IG) Corporate Debt</b>           |  | <ul style="list-style-type: none"> <li>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.</li> </ul>  |
| <b>High Yield Bonds</b>                               |  | <ul style="list-style-type: none"> <li>Current default rates in high yield are very low by historical standards. 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.</li> </ul>   |
| <b>Emerging Markets Debt</b>                          |   |   |
| US dollar   |  | <ul style="list-style-type: none"> <li>Spreads on EM debt relative to US treasuries widened substantially earlier this year in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates. However, in recent weeks EM local currency bond yields have rallied both in absolute terms and relative to US yields while EM hard currency bond yields have continued to sell off. This reflects an expectation of a less aggressive Fed, less aggressive US trade policy, and/or more aggressive China stimulus. While not all of these developments are guaranteed to move to the better direction, we upgrade EM local currency bonds given their attractive valuations.</li> </ul>   |
| Local currency  |  |   |
| <b>Chinese Bonds</b>                                  |  | <ul style="list-style-type: none"> <li>China has the third (soon to be the second) largest fixed income market in the world. Chinese bonds have the highest nominal yields among the 10 largest fixed income markets yet have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. Slowing economic growth and inclusion in the Bloomberg Barclays Global Aggregate index next year should push yields down during the next 3-12 months.</li> </ul>  |

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

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