October 2015
Asset management research

Global Asset Views

Economic and market developments in perspective

Formulating our global asset views

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

Cyclical Market Forum
To foster this exchange of views, we host a quarterly Cyclical Market Forum (CMF), which is attended by representatives from all of our investment areas: the multi-asset Global Investment Solutions (GIS) team, Fixed Income, Equities, Real Estate and Hedge Funds.

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

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

Global Asset Views – Economic and market developments in perspective
This quarterly Global Asset Views publication covers the CMF held in September 2015. It outlines the three global economic scenarios analysed by attendees at the CMF and the probabilities allocated to each, as well as focusing on their potential impact on the various asset classes. It also features the current asset allocation and currency views of our multi-asset Global Investment Solutions team.

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

Andreas Koester
Head of Asset Allocation & Currency
Global Investment Solutions
UBS Asset Management

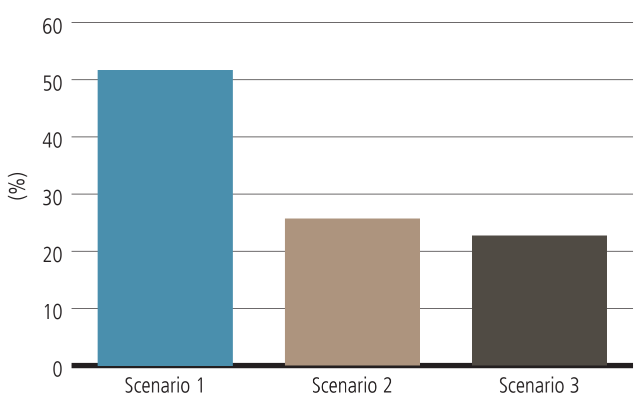
CMF September 2015: Voting patterns

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

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

Chart 1: Average probability attributed to each global economic scenario

While the consensus scenario 1 (52%) was voted the most probable, the overall voting pattern signalled clearly higher pessimism in UBS investors' expectations, with a smaller difference than in previous quarters in the percentages for scenario 2 (25%) and scenario 3 (23%).

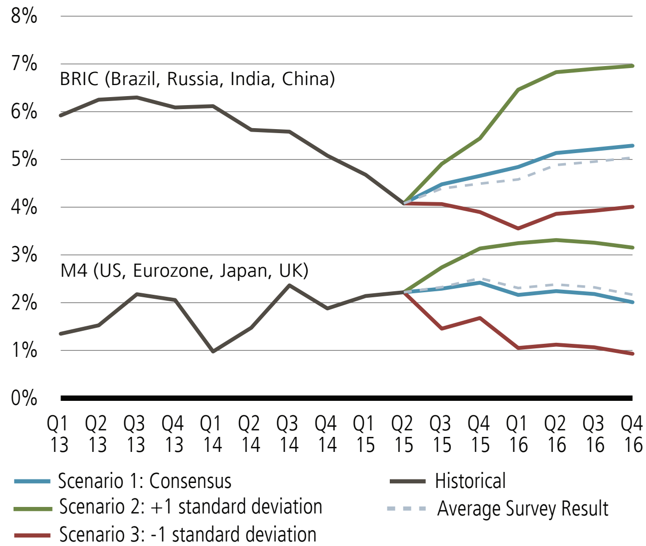


Source: UBS Asset Management, September 2015. The three scenarios are those considered by UBS Asset Management's CMF.

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

Chart 2: GDP growth quarter-on-quarter annualized

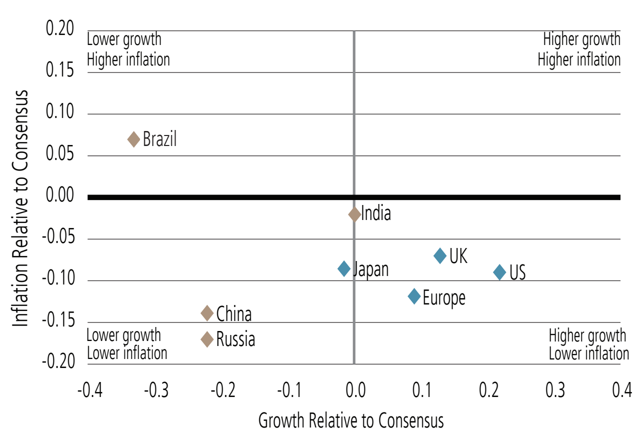
Our investors remain concerned about emerging market economic growth, which is expected to disappoint in the next 12-18 months. Developed market economic growth, meanwhile, could surprise on the upside.



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

Chart 3: Relative GDP growth and CPI inflation expectations

Relative to consensus, the average UBS investor expects higher growth and lower inflation in the US, UK and Europe. The average UBS investor is more pessimistic on the growth outlook for emerging market economies, with the notable exception of India.



Global economic scenarios

Scenario 1: Consensus (52%)

- The outlook for economic growth in the developed markets is broadly unchanged from the second quarter. The US economy should continue to lead the global recovery, with growth anticipated to be in the range of 2.5-3% per annum. Meanwhile, stronger-than-expected expansion in the Eurozone looks likely to be offset by a downgrade to the growth outlook for Japan. Emerging market economies are expected to continue underperforming their developed counterparts, as they face greater headwinds from weakening Chinese growth and the prospect of Fed rate rises.

- In the US, as the effects of falling energy prices wane, inflation progressively moves back to just above 2% in 2015. Eurozone inflation is well below target and likely to undershoot the ECB's target until the second half of 2017. In Japan, inflationary expectations are subdued.

- Chinese economic growth continues to slow, stabilizing at an official rate of just above 6.5% (although likely lower in reality), as investment is dampened by excess capacity in many sectors, construction in particular. India remains a bright spot in the emerging markets, with the economy set to expand by about 7.5% in 2015 in 2015, and growth expected to accelerate further next year. Latin America, meanwhile, appears stuck in a negative cycle. Constraints on commodity export flows and persistent government and trade deficits look likely to keep Brazil in stagflation this year.

- Consensus expectations for the global oil price appear to have lowered, with the price of a barrel of Brent crude oil likely to hover in the USD 50-60 range.

Scenario 2: Upside (25%)

- Prolonged oil price weakness has an increasingly positive effect on global consumption.

- Continued low interest rate environment leads to a meaningful increase in global investment.

- In the US, higher labor market participation leads to stronger productivity growth, while rising wage levels stimulate increased consumption.

- In the Eurozone, less aggressive fiscal consolidation and faster progress on structural reforms support demand, while an environment of lower political uncertainty brings about a revival in investment spending.

- A strong UK labor market and weak consumer price inflation boosts consumer spending.

- Stronger-than-expected developed market growth and export demand supports the Chinese economy, helping it to rebalance.

- Commodity prices rebound, supporting Brazil's lagging economy.

Scenario 3: Downside (23%)

- Chinese economic growth slows at a much faster-than-expected pace, and the adverse effects spill over to the other emerging economies.

- The Fed fails to manage expectations about the timing and pace of rate hikes, leading to significantly increased economic and market volatility.

- In the US, energy sector weakness spreads, leading to subdued growth in capital spending across other sectors.

- Increased political fragmentation and instability in the Eurozone (Spain, Italy, Portugal and Greece) leads to limited progress on structural reform, impedes a rebound in investment spending.

- The Bank of Japan significantly alters its inflation target and reduces monetary support, while corporate earnings growth prospects for Japanese companies suffer.

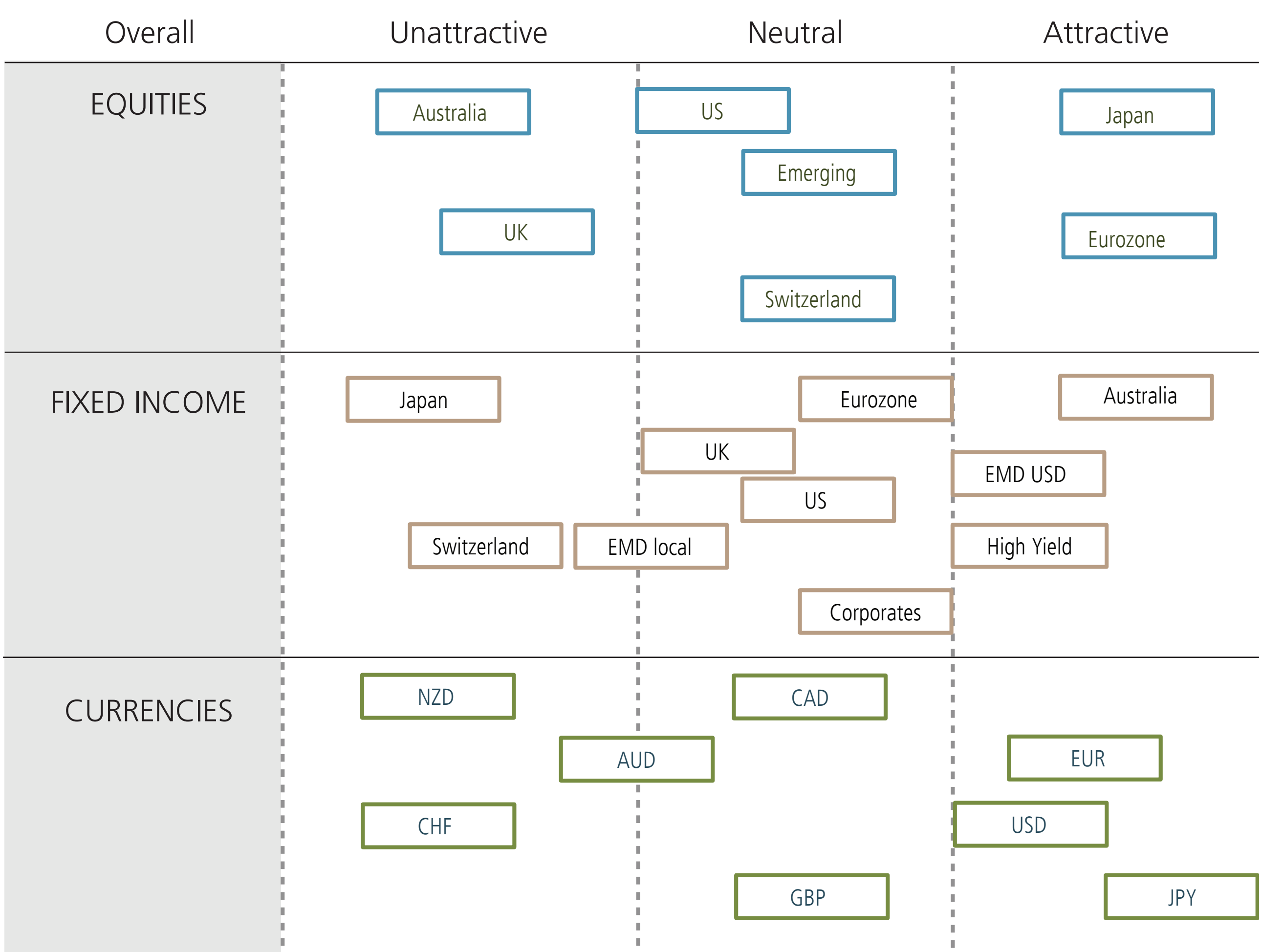
- In India, a failure of structural reforms to deliver higher growth dampens both business and foreign investor confidence.

Global Investment Solutions

Global Asset Views Q3 2015

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

Chart 4: Asset class attractiveness



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

Asset allocation

Financial market participants and commentators have devoted a great deal of time to trying to determine when the US Federal Reserve (Fed) will raise interest rates for the first time in nearly a decade. This comes as little surprise—the exercise can be as simple as tossing a coin ahead of the Federal Open Market Committee's monthly meetings.

In September, the Fed surprised many by leaving interest rates on hold, despite inflation and labor market trends suggesting that conditions were ripe for an increase. Furthermore, the US economy continued to outpace its developed counterparts in growth terms, with second-quarter GDP revised upwards and the dollar continuing to make gains against other major currencies. The Fed was thrown off course by developments in the global economy—China and the emerging markets in particular. Market expectations for the first US rate rise have now been pushed back to the end of this year or early 2016.

This leaves the prevailing environment as one of uncertainty. While many expect that the Fed will eventually raise rates, and that the pace of tightening that follows will be very gradual, September's developments showed that the monetary policy trajectory of the world's most important central bank is by no means set in stone. What will help long-term investors seeking returns across multiple regions and asset classes to cope with this uncertainty is having a good understanding of the trends shaping the real economy. In the following, we assess the key developments that caught the attention of investors in the third quarter of 2015, and which are likely to remain in the spotlight in the coming quarters.

These were:

- **China**. A surprise devaluation in the yuan and a number of weaker-than-expected data releases stoked fears that Chinese economic growth was on track to slow at a much faster-than-expected rate. The perceived inability of Chinese monetary authorities to put a floor under these losses shifted the spotlight onto the fiscal measures that could be implemented to boost the economy and, potentially, asset prices.

- **Emerging market troubles**. Many emerging market assets had a challenging quarter, including Brazilian and Russian stocks. This was caused by several factors, including commodity price weakness and currency market volatility in an environment of already sluggish growth in many heavily resource-dependent economies. Furthermore, asset prices adjusted to reflect the prospect of higher US interest rates, with significant outflows from emerging markets.

- **Continued easy monetary policy in most developed economies**. While the Fed edged closer to its first rate hike, the European Central Bank (ECB) and the Bank of Japan (BoJ) retained their easy monetary policy stances. Further accommodation on their part could be forthcoming, given the deflationary pressures emanating from China, primarily as a result of waning export demand, as well as weakness in global commodity prices. An accommodative monetary policy backdrop should provide ongoing support to the performance of riskier assets.

No shortage of surprises from China

Doubts about the reliability of official Chinese data and the distinctive state-led capitalism pursued by China's ruling elite mean that the country's economic developments are likely to provide plenty of surprises for foreign investors and commentators. The third quarter showed more clearly than before that Chinese authorities are struggling to shift the economy towards primarily consumption-driven growth.

In early August, the People's Bank of China (PBoC) reduced its daily reference rate for the yuan by 1.9%. Deemed a one-time adjustment by the PBoC, the cut led the yuan to suffer the biggest daily loss against the US dollar in over two decades. The PBoC's actions represented a step towards a more liberal currency regime and were welcomed by the International Monetary Fund. However, they also raised concerns among investors that the central bank had sought to devalue the yuan to boost the competitiveness of Chinese exporters. This in turn exacerbated fears of a cycle of devaluations among emerging market economies to retain their relative competitiveness.

Chinese economic data developments provided investors with little cause for cheer. The closely watched Caixin China purchasing managers' index (PMI) showed that manufacturing activity continued to weaken in September for the second consecutive month. Tight credit conditions, meanwhile, appeared to be constraining business activity, while the multi-year deflationary cycle in producer prices continued, according to data released in September.

Investors were alarmed by the domestic A-share market losing over 43% of its value during a period of about two and a half months between June and August (Chart 5). The measures deployed by the PBoC to normalize conditions were perceived by many as ineffective, at least in the very short term. The Chinese A-share market plunged despite the PBoC's efforts to limit losses, including restrictions on short selling and share disposals by large stakeholders. This essentially represented the bursting of a price bubble that had inflated in an environment of highly expansionary monetary policy, driven by the PBoC's repeated cuts to interest rates and reserve requirement ratios. The market eventually settled in late August at a level close to which it was trading around the start of 2015.

Chart 5: Shanghai Stock Exchange A-share equity returns one year to 30 September 2015

Source: ThomsonReuters Datastream, 30 September 2015

The Chinese authorities also ramped up their fiscal policy interventions, becoming more aggressive on planned infrastructure spending. The debt-for-bond exchange program, designed to channel increased funding to local governments for investment to boost growth, also continued to lend some support to activity. We believe there is scope for Chinese authorities to undertake further action on both the fiscal and the monetary side.

- **GIS asset allocation implications and outlook**
  We closed our long China H-share (Hong Kong-listed) vs. A-share (mainland China-listed) trade in August. Given the massive price movements seen across markets in the region over the quarter, we were provided with a good exit opportunity. We do not believe that a Chinese economic hard landing is the most likely outcome. In our view, the prices of China-linked assets appear to be overestimating the degree to which Chinese growth will deteriorate. However, a weakening Chinese economy will continue to weigh on global trade volumes, adversely affecting the world economy. We would need to see meaningful improvement in Chinese domestic consumption for our outlook to become more positive. China remains at the top of our list of global economic developments to monitor.

Waning Chinese demand sets the stage for emerging market weakness

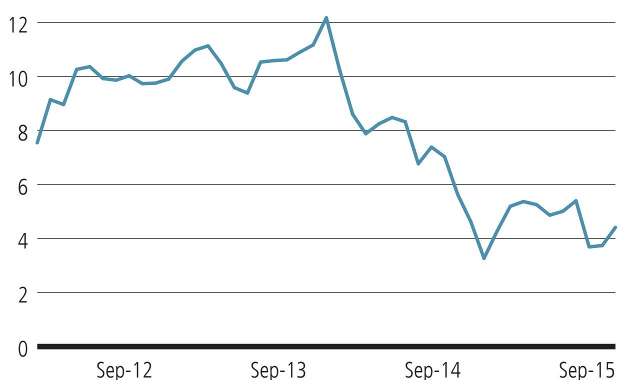
The tumultuous developments seen in the Chinese economy and financial markets in the third quarter do not necessarily presage a veering away from China's previously anticipated growth trajectory. Before the quarter's developments raised red flags for investors, most commentators were expecting the Chinese economy to slow gradually onto a path of more sustainable long-term growth—and it was factored into projections that official data from China could over-state growth rates by some margin. A gradual slowing in Chinese economic growth still remains our base case scenario.

What is clear is that waning Chinese demand for imports, as a result of the economy shifting away from investment- and resource-driven growth to consumption-led expansion, has left many emerging economies vulnerable. Among the most adversely affected have been the Latin American economies such as Brazil that have traditionally been heavily dependent on exports to China as a driver of growth. Russia, meanwhile, remains in confrontation with Ukraine and international sanctions serve as an ongoing impediment to the country's economic growth, coupled with the negative impact of oil price weakness.

There is no shortage of factors compounding the problems faced by many emerging market economies and asset classes. With the Fed set to raise rates for the first time in nearly a decade and the US dollar in a strengthening environment against most other currencies, investors have been shifting funds away from the relatively less attractive emerging markets. A stronger US dollar also means that the emerging economies that have borrowed significantly in dollars now face a growing debt service burden, at a time of domestic economic weakness, suppressed commodity prices and often high inflation.

Areas of strength remain, however, even in emerging market asset classes facing challenging conditions. India's equity market has fared relatively well compared with the broader MSCI Emerging Markets Index in the third quarter. It has been buoyed by a relatively healthy domestic economy—India has benefited from oil price weakness, and has succeeded in reducing its high current account deficit and bringing down inflation. The Reserve Bank of India is on track to reach its January 2016 inflation target of 6% (Chart 6 on next page).

Chart 6: India CPI five years to 15 September 2015



Source: ThomsonReuters Datastream, 30 September 2015

- **GIS asset allocation implications and outlook**
For us as multi-asset investors, differentiating between emerging market regions, countries and asset classes is crucial to finding the most attractive opportunities in terms of risk and reward. In the third quarter, we became slightly more positive on emerging market equities on valuation grounds, but retained an overall neutral stance. We hold a long North Asia vs. MSCI Emerging Markets equity trade. On the long side, the healthy current account balances of Korea, Taiwan and China compared with the broader emerging market universe should make them better placed to weather the negative effects of US rate rises. A low oil price will also work in their favor. In fixed income, meanwhile, our preference remains for US dollar-denominated over local currency emerging market debt.

We retain our conviction in Eurozone and Japanese equities

On the negative front, the performance of Eurozone and Japanese exporters could be harder hit the faster Chinese demand for foreign imports wanes. Consumer price pressures are likely to remain low for some time as global oil and commodity prices remain depressed. However, the flipside of this is that recent dynamics are likely to lead to the continuation of trends that have been broadly favourable for riskier assets in both the Eurozone and Japan.

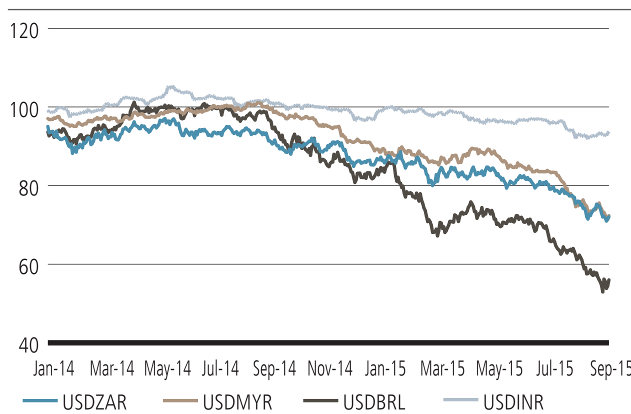
These include: the ECB and the BoJ's ongoing government-bond purchase programs and their potential expansion; weakness in the euro and the yen against the US dollar lending support to exports; a favorable backdrop for increased consumer spending, and relative political stability. Earnings growth trends for both Eurozone and Japanese companies have been broadly positive, although more so the case in Japan—and given strong corporate fundamentals, we would expect this to continue.

- **GIS asset allocation implications and outlook**
Our outlook for developed excluding US equities (MSCI EAFE) remains positive on a 12-month time horizon. The developments of the third quarter—namely in China and the emerging markets—challenged our base case scenario, however. We expect a catalyst to be forthcoming in the shape of Chinese authorities undertaking further monetary and fiscal policy measures to boost the economy and lend support to financial markets. In portfolios, we reduced our directional equity exposure and added exposure through relative trades. Retaining our conviction in Japanese equities, we added to the TOPIX vs. S&P 500 trade. We also added a new long Eurozone banks vs. broad Eurozone equity market trade. Our expectation is that Eurozone bank stocks will outperform, due to a combination of: loosening credit condition and positive loan growth; banking sector earnings upgrades; limited potential for further regulatory uncertainty, and the waning severity of debt-crisis related developments in the peripheral economies.

Currency

Amid concerns about Chinese economic growth and further yuan liberalization, emerging market weakness and the Fed's decision not to raise interest rates in September, the US dollar depreciated against many major currencies in the third quarter. Emerging market currencies, however, suffered the most, with the South African rand, the Malaysian ringgit and the Brazilian real losing significant ground against the dollar (Chart 7). The euro and the yen, meanwhile, benefited from investor safe haven flows.

Chart 7: US dollar exchange rate against emerging market currencies 1 Jan 2014 – 30 Sept 2015



Source: ThomsonReuters Datastream, 30 September 2015

We see scope for the Swiss franc to depreciate further against the euro. The franc remains overvalued, while domestic economic indicators are sluggish—the Swiss purchasing managers' index (PMI) in September, at 49.5 vs. 52.2 in August, signalled a contraction in business activity—and negative rates are incentivising capital to flow out of Switzerland. We maintain our long euro vs. short franc position, which currently has positive carry given the negative interest rate environment in Switzerland.

Elsewhere, we remain overweight the US dollar, predominantly against the New Zealand dollar. Despite our belief that the majority of the dollar appreciation is now behind us, we see some potential for further upside given the strength of the domestic economy and our anticipation of Fed rate hikes. Furthermore, the New Zealand dollar still remains overvalued and there are vulnerabilities in the New Zealand economy which we anticipate will lead to a slowdown in growth. Also supportive of the positioning is the prospect of further interest rate cuts by the Reserve Bank of New Zealand.

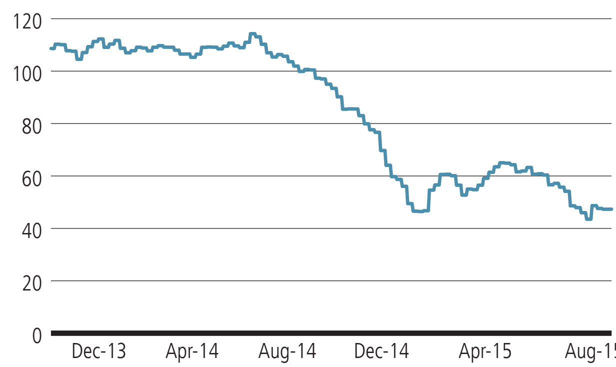
We hold several relative value currency positions in the emerging markets. We are overweight the Mexican peso. While investment in energy-related projects in the country is likely to slow due to the weak oil price, an improvement in competitiveness against China is likely to attract other significant investment inflows, particularly from the improving US economy. Elsewhere, we are underweight the Malaysian ringgit. As a major trading partner of China, Malaysia's commodity-heavy economy is particularly vulnerable to a Chinese slowdown. A deterioration in the Malaysian trade balance suggests a weaker currency may be necessary to boost competitiveness.

Alternatives

The global oil price (Brent crude) fell to a low of USD 43.5 per barrel in late August (Chart 8). This was a continuation of oil adjusting to the new world of supply and demand dynamics driving prices, rather than the Organization of the Petroleum Exporting Countries (OPEC). The market remains oversupplied in the short run but there are signs of supply contractions, cancelled new capacity investments and stronger price-sensitive demand growth.

Oil demand has been quite resilient to the slowdown in the emerging markets. Over the medium term, we expect the price per barrel to stabilize in the USD 50-70 range and the key drivers of emerging market growth, energy efficiency and OPEC policy to determine which side of that range is broken first.

Chart 8: Price of a barrel of Brent crude oil



Source: ThomsonReuters Datastream, 30 September 2015

Our outlook for base metals is positive, particularly in the case of nickel and zinc. Demand and sentiment remain weak but both metals are trading at below marginal cost of supply, while there is a lack of investment in new mining capacity. Short-term price movements are likely to be driven by investor sentiment on China, but supply conditions are likely to tighten in the medium term, causing prices to rise. The supply and demand conditions in copper look weaker and therefore we expect prices to remain muted for longer.

Outcome-oriented solutions.
Delivered.

UBS Asset Management's 33-year track record in multi-asset funds is one of the longest in the investment industry. And we have pioneered services that go beyond fund management by delivering outcome-oriented solutions to clients, whatever their needs.

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

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

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

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

For more information, please ask your regular UBS Asset Management representative.
www.ubs.com/gis

To help our clients achieve their investment goals, we can draw on five centers of expertise within the Global Investment Solutions team. Our clients can tap into one or two of these areas to meet a specific need. Or they can access a fund or advisory service that combines three or four areas to provide a holistic investment solution.

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

www.ubs.com/gis

UBS