Investing in 2017

Panorama

Global investment insights

Panorama

We asked a cross-section of our most senior investors where they saw the risks and opportunities in 2017. Among the questions we asked were:

- Where do you see the biggest risks?
- Where do the greatest opportunities lie?
- What do you regard as the potential impact from a shift towards greater populism? Are there any other changing political dynamics which could affect markets in your view?
- With monetary policy feeling extended, there is a greater focus on fiscal levers. What impact could a shift towards fiscal policy have on the investment opportunity set?

The following articles present a broad range of views. While there is consensus on some topics, others provoke diverse responses. We regard that diversity of opinion as one of our great strengths. Our breadth of expertise and holistic overview across all asset classes means we can meet our clients' investment challenges with the answers best suited to them.

Our special report, Cashflow Conundrum, focuses on a solutions-driven approach to a key issue for many pension funds: the problem of negative cashflow.

For more market insights from our senior investors and further information about our investment products and solutions, go to www.ubs.com/global/en/asset-management/research

Foreword

Dawn Fitzpatrick Head of Equities, Multi Asset and O'Connor

At the very heart of the challenge for investors in 2017 lies the push and pull relationship between central bank policy and the fiscal landscape. For most of 2016, market participants have not regarded low interest rates, anemic demand growth or low inflation as likely to change any time soon. But with his campaign commitment to use government spending and lower tax rates to spur demand growth, Donald Trump's US election victory appears to have altered the monetary and fiscal policy balance and the wider 'lower for longer' narrative in an instant.

Even prior to recent political developments, the structural imbalances and unintended consequences caused by low policy rates and quantitative easing were starting to be seen as outweighing the benefits.

In September, the Bank of Japan announced its intention to target a specific yield on secondary government debt rather than specifying the quantity of bonds it intended to buy – as it had done previously. This suggests that policy authorities are finally beginning to think differently as to how best to stimulate growth and inflation more effectively and more sustainably. The potential for meaningful change in the inflation and interest rate narrative has not been lost on investors. As 2016 draws to a close, we are witnessing a marked upward shift in bond yields.

We see increased government spending – traditional fiscal stimulus – as the next step in a number of countries including Japan, the US and the UK, dependent on budgetary constraints.

Whether this extends towards a new framework of central bank-financed government spending (so-called helicopter money) remains a key question. But any progress towards such initiatives is likely to be gradual given the political obstacles that need to be overcome.

Indeed, while 2016 has hardly been short of headline-grabbing political events, politics still has the potential to impact investor confidence again in 2017.

Dissatisfaction with establishment politics has been evident in the UK's decision to leave the EU and the victory of Donald Trump in the US presidential election. There is a busy calendar of potential flashpoints in the months ahead including general elections in both France and Germany. In short, geopolitical risks remain high.

Of course, while investors face many common challenges, we are well aware that their context and impact is client-specific. There is no 'one size fits all' to the issues that dominate markets.

In the following pages, UBS portfolio managers across a broad array of both growth- and income-oriented strategies in the traditional and alternative spaces consider the biggest risks and greatest opportunities they face as we enter 2017.

The responses highlight that the move towards increased fiscal spending and the potential for higher US inflation may benefit cyclical sectors within developed global equity markets and banks in particular. This backdrop is also likely to offer continued support to risk assets more broadly as real interest rates remain extraordinarily low relative to historic standards.

And despite the headwind of a strong US Dollar (USD), we believe that emerging market equities will remain supported by attractive valuations and powerful demographic trends. Meanwhile, an active approach and the ability to exploit tactical opportunities may be key to returns in bond markets in 2017.

While our investors highlight a number of challenges in the months ahead, there is a recurring theme throughout: dislocation in markets and changing price relationships relative to historical norms continue to present compelling opportunities across global asset classes for the right strategies and skilled investment professionals to deliver the outcomes that clients expect.

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Equities

Crowd funding

'Lower for longer' dominated global equity markets for much of 2016. Could rising inflation expectations be a catalyst for the banking sector's outperformance in 2017?

The actions of central banks and the search for yield were once again dominant themes for investors during 2016. The wider market's strongly consensual views about 'lower for much longer' are evident in a host of increasingly crowded trades across asset classes.

Within equity markets, these crowded trades include bond proxies and structured vehicles targeting isolated risk premia factors, including lower volatility. However, we believe the quantum of capital now focused on such factors presents an asymmetric risk to investors: despite recent under-performance, low volatility stocks in the US are almost as expensive as they have ever been. In our view, this strongly suggests any change in the 'lower for longer' narrative could see both the realized return and realized volatility of these factor exposures differ significantly from the recent history that attracted investors in the first place.

Inflation risks underpriced

With a surprise Trump victory focusing attention on the US as 2016 draws to a close, what and where are the disruptive forces which could further shake investors in US equities from their consensual thinking in the coming months? When we look at the macroeconomic assumptions discounted in markets, the one key area where we see widespread complacency is inflation. A Trump presidency may exacerbate those risks. 'Lower for much longer' has become accepted wisdom – and a broad investor base is positioned aggressively in the expectation that inflationary forces have been slain.

But this view flies in the face of several data points and emerging trends. Notwithstanding the doubling in the oil price over the past year, with the US economy close to full employment, we see potential for a tight labor market to squeeze wages higher still.

And while wage growth in the official US average hourly earnings statistics currently looks modest, we do not believe this is representative of cost pressures experienced by listed companies. The Atlanta Federal Reserve Bank has created a more representative wage growth gauge which is currently running at 3.3% YoY.

These higher costs are highly likely to be passed on to consumers. If they are not, margins and profitability will have to bear the brunt. Neither outcome is reflected in equity prices at the time of writing.

> "We believe the next policy step for many countries will be a greater focus on government spending rather than monetary loosening."

Rise of protectionism

It is not solely wage growth that could push US prices higher. We regard the trend towards populist politics and protectionism as inherently inflationary on a number of levels. Given their explicitly pro higher government spending stance, populist policies put demand pressure on prices – at the same time as their increased borrowing pushes interest costs higher.

Active Equities

Meanwhile protectionism simply raises the costs of imported goods while reducing overall trade. While it is easy to dismiss the rise in protectionist rhetoric as grandstanding without substance, the surprise victory of Donald Trump in the race to the White House suggests that this is a theme that is in its infancy. We do not see the trend dissipating without a significant change in economic growth or inflation.

Driven not merely by populism but by the simple fact that lower rates have not worked, we also believe the next policy step for many countries – including the US – will be a greater focus on government spending rather than monetary loosening. Low interest rates and vast swathes of liquidity have not been delivered without unintended consequences. The structural imbalances caused by excess liquidity and low rates need to be unwound before they pose a material threat to the stability of the US and global economies. For the reasons we have already explained, a shift towards fiscal spending is likely to prompt higher inflation.

Banks opportunity?

At the sector level, the combination of low/negative rates and flat yield curves have hit the profits of the banking sector particularly hard. The irony is that a policy designed to stimulate demand growth and inflation has actually disincentivised banks from lending. Globally, this has been more pronounced in Europe, where the market believes deflationary forces are entrenched, the ECB is still in expansionary mode, and where evidence of any sort of sustainable demand recovery has been fleeting to-date.

The underperformance of European banks both relative to the wider European market and to developed world banks globally has clearly been accentuated by concerns of systemic risk and fears of shareholder dilution via capital raising in Germany and Italy in particular. But a number of banks with strong capital positions and robust balance sheets have been tarred with the same brush as their lower quality counterparts. We believe that the wider market may be wrong in its assumption that central banks are unable to hit their inflation targets. Given heavily discounted valuations, there is significant potential upside in the sector should signs of inflation emerge. Additionally, it seems clear that the US regulatory regime under a Trump presidency and Republican Congress will be far more supportive of valuations than has been the case over the preceding eight years.

> “We believe that the wider market may be wrong in its assumption that central banks are unable to hit their inflation target"

What to watch in 2017
Crowded trades along the 'lower for longer' theme are stretching valuations in related market segments to unsustainable levels

We believe investors are overly complacent about the prospect of higher US inflation

A greater focus on fiscal policy is a likely next step for many developed countries, including the US, while a continuing rise in populist politics and protectionism is a trend that we regard as inherently inflationary

Where are the winners?
Banks are the biggest potential beneficiaries of higher-than-expected inflation

Emerging markets...

Powerful demographic forces support the emerging market equity opportunity set

Major risks

Are emerging market (EM) equities vulnerable to developed world central bank policy and politics, or are they backed by sufficiently powerful secular forces to suggest that we may only be at the start of a longer-term positive trend?

Perhaps unsurprisingly for an investment universe with high levels of hard currency debt, EM equities have historically shown a high sensitivity to the USD. A rapid normalization of G7 monetary policy in 2017 coupled with a much stronger USD would therefore pose a serious risk to EM asset prices via increased debt servicing costs and lower growth prospects. However, given the current low growth and low inflation backdrop in the developed world, we suggest that even if rates do move higher in 2017, the pace of increase is likely to be measured. Given both the technical and fundamental characteristics of developed market sovereign bonds, we believe that emerging markets can, and will, take this in their stride.

There are other risks though. If the growing populist and protectionist agenda across Europe and the US place restrictions on global trade then the impact on EMs is potentially negative. We will have to see whether Donald Trump's anti-globalisation rhetoric turns to action but it is clear that the risks to EMs have risen with Trump's ascendancy to the White House.

It would also be remiss not to mention China – a nation which presents both opportunity and risk in the year ahead. While 2016 opened with concerns about a China hard landing, it is the country's high levels of debt that are most likely to worry investors at some point in 2017. That said, despite the volatile start to 2016, overall, the Chinese authorities managed the structural changes in the economy far more adroitly than most observers expected.

Powerful demographic trends

Though there are risks, it is worth reminding ourselves of the scale of the demographic trends that support EMs. In particular, recent research by UBS Asset Management[1] predicted a 4.2% growth in working age population between 2015-2020; a sharp contrast with a 0.2% reduction predicted for developed countries. EM countries also have a significant advantage in catch-up potential across government spending, investment and education – all important long-term growth drivers.

But identifying the countries with the greatest growth potential is not a magic formula for maximising returns. Investors also need to understand what growth rates are already reflected in equity prices and have confidence that exposure to that growth rate will not be diluted by capital raising. On these combined growth and quality measures, countries such as India, Indonesia, South Africa and Mexico score well.

> “Private expenditure on healthcare in countries like India, Vietnam, Indonesia, the Philippines and China have seen double-digit growth over the past few years."

This growth is driving structural changes away from a focus on infrastructure and low-value exports towards domestic consumption, boosted by higher wages and a burgeoning middle class. Indeed, rising incomes are changing the consumer habits of over 400 million emerging households in countries such as China, India, Indonesia, the Philippines, Brazil, Poland and Russia – creating a young, urban and tech-savvy consumer demographic in the process.

Education, leisure, entertainment & health opportunities

At the sector level, there remains a broad array of investable plays on these themes that are still in their infancy. Education, leisure and entertainment sectors are all beneficiaries. We see an increasing focus on personal health too (ironically at the same time as higher incomes are leading to an increase in lifestyle related conditions such as obesity and heart disease). Private expenditures on healthcare in countries like India, Vietnam, Indonesia, the Philippines and China have seen double-digit growth over the past few years and we believe that this growth will continue and broaden to other EM countries – providing plenty of investable opportunities in the process.

a new normal?

Faster adoption of online channels

The rapid growth of online channels is another investable secular trend. Internet penetration is already high in parts of EM (particularly Asia), but is below 50% in many EM countries. If internet access across EMs matures to developed market levels, we estimate this will translate into an additional two billion EM internet consumers. Therefore we believe e-commerce in EMs will continue to grow rapidly, and even accelerate as connectivity becomes more affordable via cheaper handsets – potentially allowing EM countries to completely leap-frog the expensive fixed line internet infrastructure investment of the developed world.

The online retail market in EM countries could exceed USD2.5tn by 2025[2] as usage shifts from primarily social networking and gaming to more entrenched online shopping. We have already witnessed the rise of several internet service juggernauts in China and Russia. While these companies continue to grow, the next phase of growth and investment opportunities may be found in India and Southeast Asia.

Opportunities outweigh risks

We do not claim that all emerging countries and sectors offer a robust investment story. One of the principal attractions of EMs is their breadth and diversity. There will be big winners. No doubt there will be big losers too. But with an active strategy driving selection, EMs offer a scale and vibrancy of opportunity that makes a compelling argument in an investment world otherwise dominated by 'lower for longer'.

The EM economies are at the beginning of a recovery phase, with some countries already seeing an upturn in activity. Commodity prices have stabilized. EM currencies have fallen to attractive levels and we are seeing the beginning of deleveraging in most EM countries. While we characterize this as a U-shaped recovery, not unlike that of the US from 2009 onwards, this should be enough to drive outperformance of the EM equity asset class – especially considering moderate valuations and the below benchmark positioning of global investors.

[1] Riding a New Wave. Emerging markets: the new normal (August 2016)
Geoffrey Wong Head of Emerging Markets & Asia Pacific Equities UBS Asset Management
[2] Credit Suisse Emerging Consumer Survey

What to watch in 2017
Increased fiscal spending in the developed markets could be positive for many EMs, including China

Demographic trends across EM countries remain a strongly supportive long-term growth and opportunity driver

A rise in protectionism across the developed world could impact negatively on EMs

Where are the winners?
Education, leisure and health all offer investable opportunities, with ongoing growth potential

Online channels are growing in prominence, with strong growth forecast for e-commerce

Every cloud

Technology is likely to provide US equity investors with some of the most exciting opportunities in 2017

IT transformation

Writing this article from a newly-installed next generation virtual desktop environment at UBS, it is clear that the way businesses consume IT services and applications is changing fast. Whether shared via a public cloud offering or a bespoke 'on premises' solution, the benefits of cloud-based computing include significantly greater business and working flexibility combined with lower upfront and maintenance capex, plus lower energy usage.

Via its own fast-growing Web Services unit, Amazon is one of several companies aggressively seeking to exploit this opportunity to take business from incumbent providers of hardware, storage and networking. As Amazon's outspoken chief executive Jeff Bezos famously observed: "your margin is my market opportunity". The existing annual public cloud revenues of Amazon, Microsoft and Google collectively account for roughly 1% of the USD1.4tn total IT spending by businesses globally[1].

Given current growth rates and the deflationary nature of cloud spending, the increase in incremental dollars is likely to continue expanding at around 50% annually; already these numbers are getting big.

We don't believe that the disruption and opportunities from this trend are limited to hardware, storage and networking. We could see long-term disruption to pricing at the top of the stack in database, analytics, and even application software. A recent key development that further supports growth has been the ability to combine public cloud services with more secure and customized 'on-premises' private cloud solutions via so-called hybrid offerings.

Regulatory threats

But there are clear threats and risks to tech stocks too. In particular, we believe dominant US technology franchises face an underappreciated risk from regulatory considerations. In Europe, the European Commission (EC) has investigated Google for its search dominance and its ability to prioritize Google properties over third-party search results. While the EC has not formally ruled, potential remedies could include fines or the imposition of structural changes to Google's tactics and business model.

Another on-going investigation centers on Google's pre-installation of its own apps on Android devices, which bears a striking resemblance to action taken by the EC against Microsoft's pre-installation of media players and the company's Internet Explorer browser with Windows.

Both these actions arose because the EC generally frowns upon any company that owns a dominant platform that the EC believes is exploiting its strategic position against potential competition. Any structural remedies around Android could clearly hurt Google's ability to monetize mobile advertising. An expansive view of this standard could even raise antitrust issues around Amazon's efforts to sell its own private label consumer goods in open competition with third party producers.

A new 'reality'

Elsewhere, within the world of technology, we see Artificial Intelligence (AI, also known as 'machine learning'), virtual reality (VR) and augmented reality (AR – a blending of VR and real life) as three investable tech buzzwords over the next year.

IBM's Watson may be the best-known AI platform, but Microsoft, Google, Facebook, Amazon and Apple are all making significant investments in the field. A recent Morgan Stanley (MS) CIO survey showed that more than 50% of CIOs are using or planning to use AI/machine learning solutions within their enterprises. This is similar to levels of public cloud adoption that MS noted in its 2013-14 survey.

In VR and AR, further progress is likely to be swift. Consumers can already buy VR/AR headsets in the shape of Facebook's Oculus Rift and the Samsung Gear. Meanwhile, Nintendo's groundbreaking Pokémon Go game shows the potential impact of augmented reality within the videogame industry. AMD and NVidia, manufacturers of high-end computer graphics chipsets, have released mainstream processors that are VR ready. At the same time, Apple is investing in the space while Microsoft's AR headset offering - Hololens – is already shipping to developers.

Taking the wheel

Not content with impacting how we work and how we play, technology is also impacting the way we travel between work and home. Autonomous driving capabilities – or cars that drive themselves – are a dawning reality. Increased safety from 'always alert' functionality is coming at a time when governments are fast tracking legislation that could allow completely autonomous driving without a driver at the wheel. We believe that several companies have the opportunity to reap rewards from this secular shift, crossing the industrial and tech sectors.

> "The existing annual public cloud revenues of Amazon, Microsoft and Google collectively account for roughly 1% of the USD1.4tn total IT spending by businesses globally."

Genomics potential

Meanwhile, we believe the sell-off in listed biotech companies over the past 18 months due to political pressures has been overdone. We see the market bifurcating between highly innovative segments that offer clinically meaningful differentiation which will be able to retain pricing power, and low innovation areas where pressure on pricing is likely to grow. Additionally, while the surprise result of the US presidential election in no way eliminates the regulatory risk, it is likely diminished under a Republican-controlled Congress and White House.

In particular, we believe the potential of gene-editing technologies to better treat a broad variety of medical conditions is still in its infancy. The cost of gene sequencing has declined from hundreds of millions of dollars to under one thousand. We estimate that genomics has penetrated somewhere between 2%-5% of its potential clinical applications and provides strong growth opportunities over the next decade for the diagnosis and treatment of a vast range of medical conditions. This in turn should translate into significant sales growth potential.

1 Gartner Forecast: Enterprise IT Spending by Vertical Industry Market, Worldwide, 2014-2020, 3Q16 Update   Published: 14 October 2016 ID: G00302260

What to watch in 2017

Technology continues to be a strong growth story – with a compelling narrative around fast-growing cloud based services

Technology disruption is extending beyond work and leisure to travel, with driverless cars becoming an ever closer and investable reality.

Regulatory considerations could pose a threat, particularly to dominant US tech franchises

Where are the winners?

Artificial intelligence, virtual reality and augmented reality are three investable tech buzzwords for 2017

Biotech sell-off overdone in our view. We see strong growth potential in areas such as genomics

Fixed income

Divergence and diversity

An active approach and broad opportunity set are key to returns in global fixed income over the coming year

While 'lower for longer' may have lost some of its potency as investors debate the potential for fiscal stimulus, we believe that the essential characteristics of low growth, low inflation and low policy rates will continue to be persistent macroeconomic themes in 2017.

The efficacy of negative interest rates and large asset purchase programs are likely to remain a key focus for policy makers in the year ahead – not least given the increasingly obvious imbalances such policies are creating. Greater government spending may well become a part of the overall policy narrative but any such fiscal stimulus is likely to be incremental over the short term. Ultimately, its scale will be shaped by the political will and budgetary capacity in each region.

In the US, the Trump presidency brings fiscal policy to the fore, though we believe the actual impact will be moderate over 2017 in light of legislative considerations and the timing of the stimulus being implemented. In short, we believe the broad monetary policy approach will not be reversed in any substantive way in 2017.

Inflation to remain in check

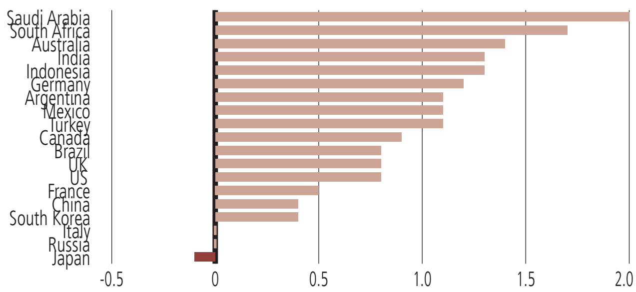
Headline inflation in the developed world appears to have bottomed now that the worst of the commodity sell-off has annualized. Continuing to frame our market views of major government bond markets is the belief that core inflation will be kept low by persistent structural forces. Excess capacity, lower population growth/ageing populations and deleveraging are secular themes that we believe will continue to keep consumer prices in check within the world's largest developed economies. Periodic spikes in market volatility are almost inevitable given investors' high sensitivity to policy change – but ultimately, a sharp increase in interest rates and widening in credit spreads would be self-defeating

Instead we believe the Federal Reserve will continue to pursue a very gradual and data-dependent approach to US monetary policy. And while we expect a 25bp hike in December, we believe that the terminal Federal Funds rate in this cycle will be materially lower than in previous cycles due to lower US growth potential and inflation. As noted above, a Trump presidency does at the margin introduce a higher degree of uncertainty around the policy mix and therefore introduces higher volatility into the market pricing of the monetary policy path.

That path has likely steepened post the US election as the expected fiscal policy action impacts the Federal Reserve's view of the neutral rate.

Growing slowly

Population growth (last 12 months, %)



Source: UBS Asset Management

Technicals driving credit

Meanwhile, credit markets continue to be driven by technical factors. This reflects the strength of investors' desire for yield enhancement in a low interest rate environment at the same time as central banks have broadened their Quantitative Easing purchases to include corporate bonds. These forces have seen a detachment from credit fundamentals. But as long as central banks maintain credibility we regard a significant widening in credit spreads as a low probability tail risk rather than our central case.

We see private debt representing an interesting opportunity and an area of growing client interest in a world of negative interest rates.

Potential risks

Where do we see the biggest risks in the year ahead? An upside surprise on US growth and inflation that pushes the Federal Reserve into a more aggressive policy path just as tapering expectations elsewhere in the world gain traction would be a meaningful shock to bond markets as matters currently stand. This threat to overall liquidity would shift the term structure of interest rates upwards, steepen yield curves and widen credit spreads.

Conversely, markets are also not prepared for another year of lower-than-expected demand and inflation surprises. If the emerging signs of improved growth and fuller employment in the US disappear at a time that capital spending remains weak and inflation soft, the likelihood is that fears of those downside risks will return to the fore. This would be exacerbated by the market knowing that monetary policy is already close to its natural limitations and that the policy responses of central banks will be challenged.

Politics threaten global growth

Political extremism also poses risks in the months ahead. The UK's Brexit vote and the success of Donald Trump signal a now widespread and confident view that nationalism and trade protection play well to the electorate while being seen to address wealth inequality. This is likely to impact politics and economics in many ways. These include a further weakening of global trade, which may raise fresh fears of a Eurozone break-up and increase concerns around regional political aspirations and associated instability.

Any deterioration in Chinese growth is likely to result in a negative feedback loop for global trade which has already seen a cyclical and structural slowing in underlying trend growth. Should this occur, it will likely spill over into the broader emerging market complex and result in a re-pricing of these markets following their strong performance over 2016.

Active opportunities

Finally, we believe that the influence of large savings pools globally will remain in place in 2017 as both retail and institutional investors seek out non-negative yields. Fixed interest index returns are expected to continue to outperform cash. In this environment, we believe diversified, multi-sector income strategies offer clients access to a broad investment universe – one in which active management enables our portfolio managers to capture the increasing number of relative value opportunities that exist to enhance returns. Incorporating some exposure to inflation-linked securities or derivatives also provide a tail-risk hedge and an opportunity to benefit from higher than expected inflation outcomes.

What to watch in 2017

Effectiveness of monetary policy will come under further scrutiny with incremental moves towards fiscal policy possible and the US leading the way

The Federal Reserve is likely to maintain a data-dependent approach to monetary policy – we believe terminal Fed Funds rate in this cycle will be significantly lower due to fragile growth and inflation outlook

Risks include a more aggressive policy path from the Fed if US growth and inflation surprise to the upside

Where are the winners?

Private debt could represent interesting opportunities in a world dominated by low interest rates

Active management in an environment of heightened volatility offers investors opportunities to access a broad investment universe via diversified, multi-sector income strategies

Hedge funds

Coping with consensus

We talk to Bruce Amlicke, Managing Director, Hedge Fund Solutions, who discusses some of the major investment themes in 2017 – from crowded trades to a new fiscal narrative

What are the biggest risks to markets in 2017?

While the recent US election has led to renewed enthusiasm over higher rates and a steeper yield curve domestically, at the time of this writing, we are still faced with an environment of low absolute yields, tight spreads, high equity multiples, flattish curves and low volatility (implied and actual). These are all a manifestation of the 'yield chasing regime' driven by unprecedentedly loose monetary policy, of which quantitative easing is just a part. Whether the new administration is able to spur sustainable growth with manageable inflation is an unknown. However, the secondary impacts of several proposed policies speak to further global economic malaise, which would ultimately result in more of the same.

What concerns us most about markets is our belief that the level of 'group think' has never been higher. We are seeing more crowding in certain equity strategies, a strong consensus that inflation will be controlled and a belief that somehow growth will be positive. Confidence in this scenario has emboldened investors to take on more risk. This includes chasing less liquid, longer duration fixed income opportunities. The bottom line is that any coordinated global regime change related to fiscal policy or helicopter money is likely to drive a very painful re-alignment of yields and spreads to higher levels.

Deteriorating liquidity is also a potential risk in 2017 as regulatory capital measures cause banks to step away from their role as intermediaries. While algorithmic trading provides market liquidity in 'normal' conditions, this liquidity tends to disappear when volatility spikes. That's when flash crashes can occur.

What sort of strategy is likely to prosper in 2017?

The market environment for most of 2016 has lurched between a grinding, low volatility, yield-chasing regime and sporadic periods of high correlation dislocation. Very few stand-alone strategies are able to prosper in both scenarios so we see diversification as critically important going into 2017.

Despite challenges across many broad strategies, there are episodic opportunities at the security level. By sourcing co-investment opportunities we align ourselves with very specific strategy experts where we have a better sense of upside, downside and the probability of achieving those outcomes.

Additionally, the uncertainty around Trump's ability to drive growth is likely to revitalize volatility in the rates markets which should provide a fertile backdrop for fixed income relative value hedge funds. As we transition to a more volatile investment backdrop, we are looking to source cheap optionality in fixed income, FX and corporate bond markets to mitigate the risk of 'market gaps' in the less liquid markets.

What broader industry trends are you seeing?

Investors are desperate to find uncorrelated returns and are pursuing various tactics to accomplish their goals in a lower than expected return environment:

This includes squeezing managers and intermediaries on their fees and using underperformance as an effective negotiating lever.

There is also a growing risk tolerance amongst investors due to the asset floor that policy makers have provided to markets. We are seeing this play out in two key ways: first, a greater willingness from investors to tolerate volatility if it comes with higher returns; second, openness to exploring co-investment strategies and less liquid credit investments to achieve differentiated returns.

Does greater populism threaten markets in any way?

Left unchecked, the current shift toward populism is likely to introduce headwinds to markets: essentially, it is putting globalization into reverse. This is likely to lead to inflationary pressures and a smaller global GDP pie. The negative economic fallout will only fan the flames of discontent, making them structurally permanent.

Higher inflation plus growth headwinds equal stagflation. This is a difficult backdrop for risk assets. Any meaningful paradigm shift in this direction may well lead to significant market disruptions at a time when the central banks can offer no remedy. In the hedge fund world, trading strategies such as systematic trend followers and global macro managers could excel in such an environment.

Would a shift from a focus on monetary policy to a greater focus on fiscal levers impact hedge funds' opportunity set?

Both long-only and hedge fund investors are in the early stages of pivoting toward a more active fiscal policy narrative. Widespread fiscal action should drive volatility and dispersion to healthier levels – conditions that hedge funds generally are well placed to monetize across a broad range of strategies.

In recent years, central bank actions have dominated fundamentals as the primary driver of asset prices. With intelligent fiscal policy, we would likely see a wide variety of sectors benefit – initially from government spending and, ultimately, greater consumer demand for improved products and services. This would certainly make equities more attractive as growth prospects improve but it could well drive investors away from bond-like equity plays to more cyclical investments. A Republican-ontrolled US administration and Congress may point to a more attractive fundamental equity long short environment but it is too soon to say.

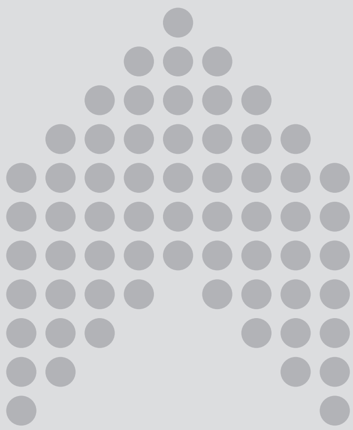
In addition, higher inflation created should steepen yield curves, drive yields higher and create a wide variety of relative value opportunities within the fixed income arena that we believe we are well positioned to exploit.

What to watch in 2017
Diversification is a key message for 2017 with so many crowded trades along the 'lower for longer' theme

We are seeing risk tolerance increase among investors – a trend that will likely continue into 2017

Risk tolerance can offer opportunities – it can also presents risks particularly if there is any sharp regime change around fiscal policy in 2017

Where are the winners?
Higher inflation and lower growth are an ideal backdrop for trading hedge fund strategies such as Systematic Trend and Global Macro funds



Opportunity set

Regulatory reform, structural market changes and growing M&A activity are providing an opportunity-rich backdrop for a number of focused hedge fund strategies

Regulatory change creating opportunities

When it comes to potential upside for 2017, we see significant opportunities for attractive, uncorrelated returns in credit where regulatory change has created market dislocations. One particularly attractive example of this is within the private credit market, where demand for small- to medium-size loans remains high at a time when financial reform has significantly impacted the ability of large financial institutions to extend that credit.

We estimate that over USD1tn of credit availability has been pulled by financial institutions adjusting to regulations such as Dodd-Frank and Basel III. This lending gap is creating a significant opportunity for investors to access an innovative return stream via private credit investments. We expect this opportunity to extend well beyond 2017 and see it as offering a particularly compelling risk/return profile.

The retreat of bank risk capital is creating a similar imbalance between the size of global mergers and acquisitions and the pool of capital willing to accept the risk/return profile of investing in a merger arbitrage strategy. An increasingly global marketplace and volatile currency pairs are generating significantly diverging views on the value of some businesses between the markets and strategic global buyers.

This is likely to drive continued cross-border M&A in 2017 which, when combined with the currently complex regulatory market, could drive structurally wider rates of return for investments in the strategy in 2017. We believe this backdrop will continue to make merger arbitrage strategies one of the investment stories of 2017.

Finally, we are seeing conflicting forces present a unique relative value opportunity in US credit. US corporates have taken advantage of historically low yields to term out financing needs and fund both M&A and share repurchases. Much of this incremental supply has been met by foreign investors making a broad-based asset allocation decision in the search for yield rather than taking a fundamental view on individual credit.

These developments come at a time when large global banks have dramatically reduced corporate debt inventory levels. In combination, these forces are presenting consistent relative value opportunities on a tactical basis where excess returns can be achieved without taking overall credit market risk.

Inflationary risks

On the flip side, the biggest risk we see to asset markets in 2017 is a rapid increase in global inflationary pressures to which global central banks are required to respond with a withdrawal of accommodative policy. While we do not see this as our base case, such a scenario would pose a significant risk to wider markets where the majority of investors are heavily geared towards low rates.

We also believe that 2017 will be punctuated by politically-driven volatility. With 11 elections scheduled to take place in Europe in 2017, as well as the first formal steps in the UK's fractious departure from the EU, political risks are likely to shape the course for risk assets against an otherwise benign macroeconomic backdrop.

Those political risks are elevated by the rise of populism and protectionism. The economic consequences are potentially profound as policy agenda shift away from trade and immigration growth – both of which are secular drivers of GDP in the developed world.

Shift to fiscal policy

Other likely impacts of increased populism include a move towards more expansionary fiscal policy. The likelihood of greater fiscal spending is also supported by the failure of monetary policy to give any sustainable boost to aggregate demand and inflation expectations.

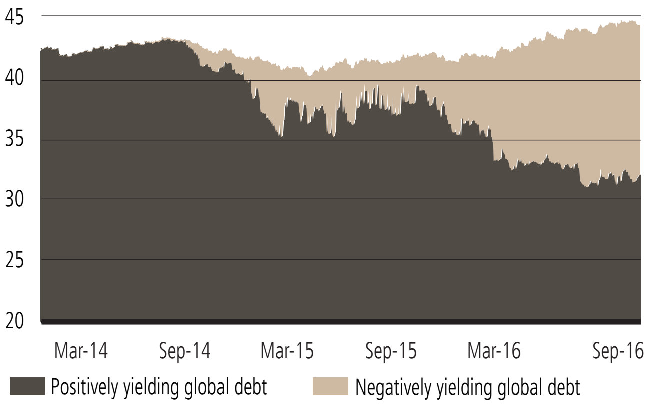
Along with higher growth, increased fiscal accommodation may also lead to higher inflation and rising real yields – supportive for inflation break-evens, real assets and commodities in the short-term. Within equities, industrials and hard commodities should be the initial beneficiaries of a pickup in fiscal spending, particularly if it is geared towards investment in infrastructure.

For investors very accustomed to capital appreciation on their fixed income investments, this scenario provides a somewhat uncomfortable backdrop. We believe 2017 will likely bring a renewed focus on current yield as coupons will be the primary driver of returns.

Similarly, as inflation becomes a bigger topic and risk for the markets, investors may well become more sensitive to the inflation protection characteristics of investments, making some commodities and products like TIPS more appealing.

Sinking Lower

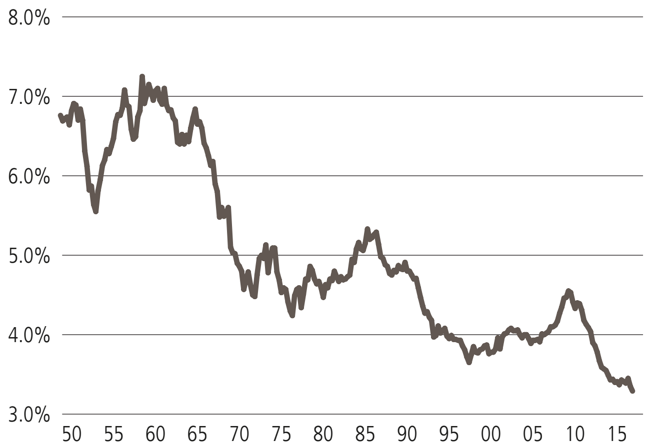
Negatively yielding global debt vs positively yielding global debt



Source: UBS Asset Management

Slippery Slope

Gross Government Investment as % of GDP



Source: Haver Analytics

What to watch in 2017

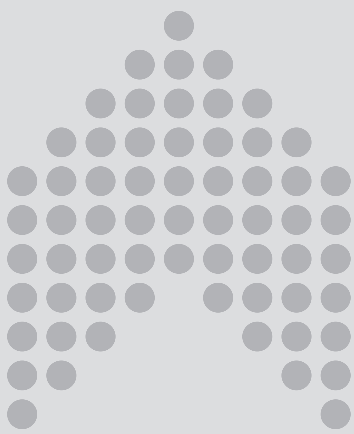
The impact of regulatory reform has impacted the ability of financial institutions to extend credit, creating a significant lending gap. Private credit investments could offer an innovative return stream – a trend we expect to play out into 2017 and beyond

Merger arbitrage looks to be a compelling story for 2017, with more complex cross-border M&A deals likely to remain a key feature

With a heavy election timetable in Europe through 2017, a fractious exit from the EU likely for the UK, and a growing tendency towards populism and protectionism, we foresee markets punctuated by politically-driven volatility

Where are the winners?

The move towards populism and increased fiscal spending should support inflation beneficiaries including inflation break-evens, real assets and infrastructure-oriented equities. We see a unique relative value opportunity in credit driven by technical factors and the changing structure of the credit market



Real estate

Fringe benefits

Continental Europe is our favoured region for real estate in 2017

Going into 2017, our view for global real estate over the next few years is largely framed by the belief that we are almost certainly in an environment of lower returns which will be driven by income.

The challenge of low returns is hardly unique to the property sector. Arguably, there are other asset classes which will be hit harder, including those where valuations are more stretched (developed world fixed income), or which do not have the comfort of long-term contractual lease income which property offers (equities).

Indeed, given that at one point, almost 40% of government debt in parts of Europe and Japan traded with a negative yield in the secondary market, property yields are attractive by comparison. The November US election result may see a temporary decline in long-term bond yields, which would flatter the relative pricing of real estate. However, the worry for all asset classes after such a protracted period of excess liquidity is what will happen when the central banks start to curtail their easing operations.

It is entirely possible that the catalyst for any significant market reaction starts not with the raising of policy rates, but rather at the point when central banks start to reference an end to quantitative easing. The abundance of cheap money dumped by central banks has driven a high level of distortion, which suggests that any sudden re-pricing of risk would affect all asset classes. And after the strong performance of recent years, many investors we meet ask whether global real estate could undergo a repeat of the sell off-seen in the last cycle.

Quality focus

In our view, compelling evidence exists to suggest investors are a lot more focused on the quality of the properties they are buying now than they were in 2006-2007, when the prices of both top and secondary quality locations and properties narrowed significantly. We believe their conservative approach towards buying and the prices they have been paying is positive for the market's outlook.

Today, the yield spread for good quality property compared to the risk-free rate stands above its long-term average in many locations while occupational markets are broadly healthy. In our opinion this mitigates the initial upside risk to property yields from a rising risk free rate.

But should yields compress further, this argument would weaken. If a rise in interest rates is due not to strengthening economies, but rather to a snap-back in secondary bond markets as a result of less central bank buying, then this argument would weaken as well. As a real asset with a residual value property is partially protected and prices have not risen as aggressively as in some other asset classes. But real estate is not immune and we believe that values would suffer should risk suddenly be re-priced.

> “In our view, compelling evidence exists to suggest investors are a lot more focused on the quality of the properties they are buying now than they were in 2006-2007."

Value creation strategies

Against this backdrop investors are focused on specific, quantifiable value creation strategies and are wary of anything that relies on yield compression. We believe one of the most attractive risk-adjusted opportunities in commercial global real estate globally lies in short-term upgrades. While the supply picture is beginning to change, a lack of construction means prime area rents are generally very expensive. We believe that taking Grade B- office space on the edge of the central business districts and fixing it up to Grade A- standards to target rent-sensitive tenants who want to be near the prime areas continues to offer attractive returns.

We also favor markets where the spread to the risk free rate is well above its long-term average, such as Australia, Spain, Italy, certain areas of the US, and parts of Germany. We also recommend maintaining a healthy buffer when it comes to leverage.

Pros and cons of populist politics

Meanwhile, the rise of populist politics and the trend towards 'local' at the expense of 'global' clashes directly with the direction that property investment has taken in recent years. More and more investors have expanded into real estate investment beyond their home markets. Tax disadvantages for foreign investors have been rolled back, but this process is shifting. Residential is leading the way, with many countries now levying punitive taxes on foreign buyers. Following the Trump election victory in the US and Brexit vote in the UK, populist themes look likely to become more entrenched and this may spread to commercial property as well, making cross-border property investing less attractive. The tone of the Trump presidency is likely to be one of globalization constraints, trade reversals, and limited immigration. We think the impact on commercial real estate investment will be minimal in the short term and difficult to predict in the long term.

But there are advantages from populist politics too – not least the prospect of increased fiscal spending in a number of major developed world countries. Much of this speculation centres on higher infrastructure investment, which President elect Trump has promised to increase significantly in the US. We see this as a long-term benefit to commercial property investment; improved infrastructure enhances the amenity of different parts of a city and increases the utility – ultimately raising the value of properties in areas benefitting from infrastructure investment.

By way of example, consider the positive impact which Crossrail – London's new high frequency underground commuter line, due to open in 2018 – is having on London's residential and commercial property markets. Similar shifts can be seen in Shanghai as it also expands its metro network. Increased infrastructure spending by governments may well benefit property investment in the targeted areas, but it is important to remember that the impact is likely to be gradual and long-term rather than immediate.

From a real estate perspective, what parting advice would we offer investors for 2017? Quite simply, watch central banks closely. Very closely. And carefully monitor the new US administration for the policies it will implement and their impact on the real estate sector.

What to watch in 2017

Property yields remain attractive relative to government debt

We see clear market differentiation and investors' focus on quality as evidence that markets are not over extended

Notwithstanding, property will not be immune from any sudden re-pricing of risk, should central banks start to withdraw from QE

Where are the winners?

We favor a focus on specific asset-improvement strategies with embedded value-creation potential

Continental Europe is forecast to outperform other regions, but that performance is heavily front loaded

Focus on best locations and/or properties benefiting from structural changes in how real estate is being used, for example modern distribution warehousing or multifamily in key global cities

Infrastructure & private equity

Focused opportunities

Infrastructure and Private Equity both offer potential return drivers with built-in resilience against the macroeconomic backdrop

Infrastructure

As 2016 draws to a close, both the private and public infrastructure markets have seen high levels of global liquidity push existing asset prices higher rather than drive investment in new capacity. Investor preferences for brownfield projects (i.e. existing operating businesses), generally regarded as materially lower risk, have continued to prevail rather than investor appetite for investment in new capacity.

Despite recent rhetoric from governments and multi-government fora (G20, IMF and MDBs more generally) emphasizing the economic growth benefits of infrastructure investment, governments have been slow to increase expenditure on infrastructure or accommodate risk-sharing arrangements which encourage private sector investment. The combination of fiscal restraint and risk-averse private investors has hampered investment in new capacity at the same time capital has flooded into the sector driving up the prices of operating infrastructure businesses.

The potential shift in attitude to more expansionary fiscal policy noted in the introduction to this volume is positive for the sector, as would be innovation on risk sharing between the public and private sectors to help accommodate existing investor risk preferences. The latter would assist in expanding infrastructure capital expenditure while assisting fiscal discipline.

Strong institutional interest

With low base rates and low credit spreads over base rates, financing costs for infrastructure projects are at historically low levels. As the search for consistent yield is the dominant theme across markets, it should come as no surprise that institutional allocations to the asset class continue to increase. It therefore follows that the high asset price trend is expected to continue in the infrastructure sector.

With investor risk appetite changing relatively slowly to the point where institutional investors are willing to look at opportunities involving development and construction risk – and to a lesser extent, emerging market risk – private infrastructure debt provides a lower-risk way for investors to access new greenfield project opportunities.

Funding gap

Traditionally, banks have been the principal source of finance for privately funded infrastructure projects. But a more stringent capital adequacy and minimum capital requirement regime imposed on banks post the financial crisis has made it significantly more challenging for them to participate in long-term project financing.

The obvious gap this has created provides the private debt market with an opportunity to offer funding for infrastructure debt finance. Within the corporate debt market, the infrastructure sector has the lowest default rates and lowest losses given default. It follows that we see a wide range of opportunities and the prospect of strong risk-adjusted returns from infrastructure debt.

Government emphasis on fiscal expansion through infrastructure investment looks set to increase and is likely to result in more government sponsorship through risk-sharing structures such as public private partnerships (PPPs) in order to deal with the risk preferences of investors, while at the same time containing public sector debt burdens. For example, the policy platform of the Trump administration in the recent US presidential election emphasized a material increase in infrastructure expenditure as a key element for stimulating economic growth.

Looking forward, we believe the most attractive opportunities for returns are likely to be found in smaller- and mid-sized assets, assets where material capital expenditure is required, and turn-around assets. Larger, operational assets are already a crowded investment space.

Private Equity

The Private Equity (PE) sector has remained very resilient in the face of financial crises and low growth. Returns have consistently outpaced public market returns. Leverage in the sector has been refinanced on favorable terms and, with the exception of Q4 2015 and Q1 2016 when the oil price rout spooked markets, investment exits have generally been very strong. Our expectation is for exit activity to remain strong albeit at slightly lower levels than in the last three years.

The high level of capital returned to investors and subsequent reallocation to the sector means there is a large amount of dry powder to be invested in new opportunities, suggesting the sector could see private market transactions play an increasing role alongside the traditional private to public market exit.

From venture capital to large buyout funds, PE as an asset class has a wide variety of investment strategies that can provide good risk-adjusted returns, with many focused opportunities, either sector-based or directed at different stages of the corporate growth cycle.

Preference for focused strategies

Larger general buyout funds have raised substantial amounts of capital and are now focused on large deals to employ that capital. But buy-out strategies do not necessarily represent the best value sector across the broader PE market. In our view, the more focused strategies may offer better returns. Importantly, in a low growth environment funds and strategies can be found which access growth opportunities in particular market segments or at particular phases of the corporate growth cycle.

Sectors which we believe offer particularly interesting opportunities include:

- healthcare driven by demographic and fiscal pressures;
- scientific developments and technical innovation;
- disruptive technology, including a rapid increase in interest in Fintech; and
- regionally focused funds, including emerging markets.

There is also increasing focus on environmental, social and corporate governance (ESG) across both infrastructure and PE. As well as capital flowing to specific ESG-focused opportunities, institutional investors together with private equity managers are pushing new industry standards for ESG investing.

Overall, in the context of a relatively low growth world with associated expected returns lower than average realized historical returns we see a strong investment case for private market investment solutions. Both infrastructure and private equity provide access to niche private market strategies.

What to watch in 2017
Government emphasis on fiscal expansion through infrastructure investment suggests public private partnership opportunities are likely to increase

Private equity provides a number of investment strategies that are resilient against a low growth backdrop – we expect this trend to continue into 2017

Where are the winners?
Private infrastructure debt and private equity growth strategies both look interesting

We see promising opportunities across a broad range of science and technology sectors e.g. healthcare and technology

Regionally-focused funds, including EMs also show potential

Special report

Cashflow conundrum

How market and demographic factors are impacting pension fund cashflows – and what to do about it

Against a backdrop of lower bond yields, lower market returns and rising life expectancy, the issues of widening funding gaps and increasing liabilities have understandably dominated the mind space and actions of many defined benefit pension scheme trustees and their advisers.

But those same market and demographic forces are creating a third issue that has received far less coverage despite its prevalence: negative cashflow – as payments out of schemes exceed those coming in.

In the corporate pension world, this reflects the fact that most schemes have now closed to new members and, increasingly, to future accrual. Meanwhile, in the UK, local government schemes, while still open, have seen their contributions decline rapidly as public sector workforces have been cut.

Industry research suggests that while there have been attempts to address the issue, the majority to-date have been piecemeal in nature. Solutions such as income stripping, asset sales and maintaining higher cash balances can – when employed in an unstructured fashion – exacerbate other investment problems, most commonly by impairing a scheme's long-term growth prospects. Our interaction with clients suggests that the governance challenges are equally significant and pressing.

Liquidity and capital stability

But what are the key characteristics of a successful solution past the generation of predictable and frequent cashflows? We see liquidity as an important consideration. Priorities change and liquidity gives essential flexibility should a new objective come into focus. We also see a degree of capital stability as a key characteristic for similar reasons – giving confidence in other investment decisions as well as in the redemption value should priorities develop over time.

A pension scheme's overall investment strategy must therefore strike a careful balance between meeting liabilities, achieving growth and achieving a stable cash flow while ensuring a robust governance framework that helps schemes achieve their long-term objectives.

A multi-dimensional problem

We believe a multi asset approach is well suited to assist with this multi-dimensional problem. Equities offer a number of desirable characteristics. These include the potential for capital growth with cashflows via dividends that are likely to grow in-line with inflation. However, the precise level of income may be unpredictable and the underlying asset, while generally liquid, can be volatile.

At the other end of the spectrum is high quality, short-duration fixed income with highly predictable cashflows, low capital volatility and high liquidity. However, these benefits come at the cost of any opportunity for capital growth – and with the prospect of exceptionally low yields at present. This is exacerbated once the impact of inflation is taken into account.

Investing in credit clearly has income benefits but comes with lower capital security and the higher trading costs of lower liquidity. Some real assets, such as property and infrastructure, can provide excellent sources of long-term income. However in the event of unforeseen circumstances, the capital may not be readily realisable.

Considerations for addressing cash flow negativity

	Cash	Bonds	Real Assets	Equities
Stable & predictable cashflow	High	High	Medium	Low
Frequent cash flow	High	Medium	Medium	Medium
Size of cash flow	Low	Low	High	Medium
Capital growth	None	None/Low	Medium	High
Volatility of capital	Low	Medium	Medium	High
Inflation protection	Low	Low	Medium	Medium
Liquidity of underlying	High	Medium	Low	High

Source: UBS Asset Management. For illustrative purposes only

Diversified income

The key point from this gallop through the asset classes is a simple one: no single asset offers a panacea for the cashflow challenge, but combining asset classes into a single cash generative solution with the ability to navigate the market cycle may be appropriate for many.

In particular, the multi asset approach also allows for the tailoring of asset allocation to an individual pension fund's specific requirements. Characteristics such as whether the scheme is open or closed; the size of its governance budget; and whether it is in deficit or fully-funded will likely influence how the scheme prioritises meeting long-term liabilities, generating growth and achieving positive cash flows. How a scheme prioritises these challenges will, in turn, influence the asset mix which it employs.

Governance challenges too

In understanding how to respond to negative cashflow, trustees need to address key governance issues too. These include determining what the end goal of the pension scheme is: a buy-in or a buy-out? While a date when benefit payments cease can be predicted, schemes that wish to achieve self-sufficiency will increasingly require near-term as well as longer-term streams of cash – and which preferably don't hinder the schemes' growth requirements.

Schemes with a larger governance budget may wish to allocate to individual asset classes or create bespoke portfolios focused on the delivery of income. But for schemes with a smaller governance budget, the utilization of a pooled diversified income solution may be optimal – in much the same way that diversified growth funds addressed the need for capital growth while alleviating the governance burden.

As we head into 2017, it is clear that pension schemes – both globally and in the UK – are facing a number of complex challenges of which negative cashflow is likely to become an increasingly issue for many. Partnering with providers of diversified income strategies potentially offers both key investment and governance benefits in the fight to address these issues.

About the authors

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Your global investment challenges answered

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Our teams have distinct viewpoints and philosophies but they all share one goal: to provide you with access to the best ideas and superior investment performance.

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Backed by the strength of UBS, we are a leading fund house in Europe, the largest mutual fund manager in Switzerland and one of the largest fund of hedge funds and real estate managers in the world.

[1] Thereof around 1,100 from corporate center. Data as at 31 March 2016

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