Global Perspectives

Overview

- **Equities:** We continue to favor equities over cash and fixed income as corporations should benefit from a solid US economy, low interest rates and structurally lower oil prices. We are focusing our overweights on markets outside of North America.
- **Fixed Income:** We have upgraded our assessment of global corporate bonds from unattractive to attractive as yields and spreads have risen; and our view is that we are at an earlier stage of the credit cycle than previously believed.
- **Currency:** We believe we are still in a strong US dollar environment and, therefore, continue to hold the currency as our largest overweight and continue to be short the New Zealand and Australian dollars.

The month in review: Risk is rewarded

- Being long risk assets paid off for investors in February, particularly in equity investments. Europe's primary defense mechanism, kicking the can, had the effect of calming investors in February as markets welcomed the progress, albeit a temporary solution, on Greece austerity pushback.
- We are beginning to see green shoots from the eurozone, with Q4 GDP surprising to the upside, retail sales in Spain and Germany surging, and euro area composite PMI ticking up.
- In Japan, economic data remains mixed but equity markets were buoyed by a strong earnings season, which comes off the back of a weaker yen resulting from Bank of Japan actions.
- During her very balanced testimony, Fed Chairperson Janet Yellen gave us insight into the Fed's secret word, "patient," which, if included in the Federal Open Market Committee (FOMC) statements, means rates will not rise for at least a couple of months in the US.

Outlook: Being selective is key

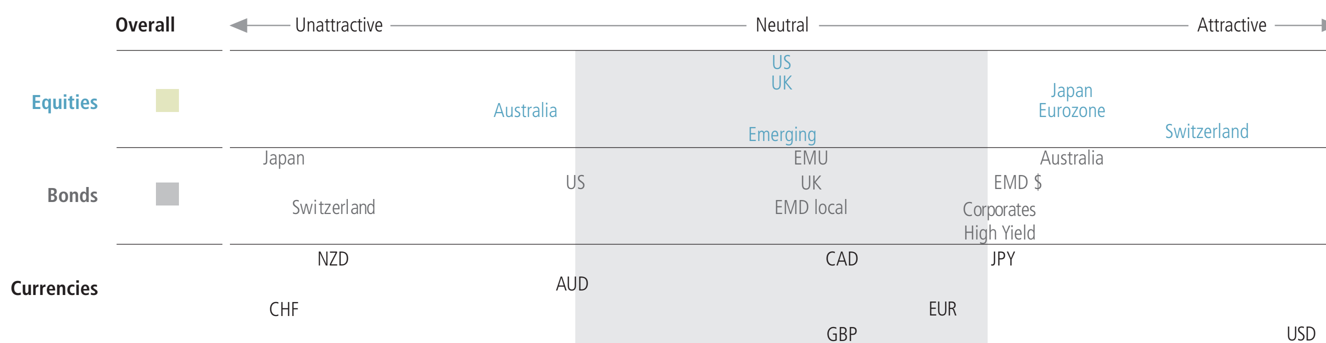
- We remain constructive on global developed equities and are focusing our portfolio overweights on markets outside of North America (MSCI EAFE). We feel more confident in these markets than the US, which could come under pressure from an improving labor market, a stronger US dollar and Fed normalization.
- Bonds that are offering attractive yields amid central bank easing, such as Australia and peripheral Europe, are appealing. We have upgraded our assessment of global corporate bonds from unattractive to attractive as yields and spreads have risen, and our view is that we are at an earlier stage of the credit cycle than previously believed.
- We continue to believe we are in a USD strengthening environment based on the economy's strength, the prospect for higher rates and the comeback as a stronger reserve currency. We see particular appreciation potential against the New Zealand dollar and Australian dollar. The major risk at the present stage is that USD is over-owned in the market.

Current views[1]

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

Overall signal =

Positive ◄—► Negative

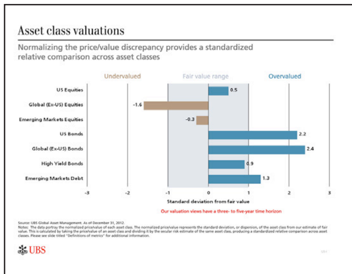


Asset Class	Signal	UBS Global Asset Management's viewpoint
US Equities		• While we remain constructive on global equities, we are seeing pockets of opportunity outside of North America where we see more attractive valuations and central banks committed to easing. • US margins have remained resilient but may face future pressure amid an improving labor market (wage rises), a falling US dollar and Fed rate normalization.
Global (Ex-US) Equities		• Certain markets outside of the US, such as Europe and Japan, also look attractive. In Europe, attractive valuations are supported by the European Central Bank's (ECB) version of quantitative easing, which should have the effect of pulling down bond yields and pushing up equity prices. • We also continue to hold an overweight to Japan, where attractive valuations are supported by a very accommodative central bank, and the hope that structural reforms like the corporate tax rate cut will have a positive impact on the economy. A strong earnings season provides positive momentum for the Japanese market. • While the UK looks attractive on a valuation basis, we prefer European equities due to the ECB providing support for risk assets. The earnings trend has been negative and the UK equity market has a high exposure to energy.
Emerging Markets Equities		• While from a valuation perspective emerging markets appear broadly attractive, no real productivity gains and lack of structural reforms put them at risk. This is particularly the case during periods of falling oil and a rising US dollar. • Opportunity is arising from this global backdrop and we prefer North Asian emerging markets over the broader emerging market index. These countries are less exposed to geopolitical risk and structural issues, and are net importers of oil.
US Bonds		• We have low conviction on an outright duration call at this point in time, but prefer long-dated Treasuries over short-dated bonds as we believe further flattening is to come in advance of the Fed raising rates. • Policy error risk is relatively high and higher volatility should be expected. March could be a decisive month to predict further US Fed action, as we anticipate the central bank to modify its "patient" wording, which is an indicator of when the Fed will begin to raise rates.
Global (Ex-US) Bonds		• Australian bonds are currently looking attractive due to high cash rates and the fact that we are unlikely to see a rise in rates in the near future. • Japan continues to look attractive as a funding leg due to extremely depressed yields and a flat curve structure. The Bank of Japan remains a risk to a short position as a large buyer of government bonds, and we continue to monitor their action. • The uncertainties surrounding the upcoming UK elections could lead to a renewed interest in gilts, which explains why we continue to see gilts as more attractive than US treasuries.
Investment Grade Corporate and High Yield Bonds		• Given negative bond yields across a large portion of European debt, we expect significant flows into investment grade corporates as investors see the asset class as a close substitute to government bonds. • The spread on high yield has improved significantly from only a year ago and we feel that investors are now appropriately compensated for the risk taken. We remain diligent in monitoring potential liquidity issues from here.
Emerging Markets Debt		• Emerging markets debt is now offering attractive yield, but a granular view by country is necessary as commodity exporting countries face the adverse impact on the current accounts and their ability to service debt due to falling commodity prices. • Our preference is for emerging markets debt in hard currency due to potential emerging market currency weakness.
Currency		• We continue to believe we are in a USD strengthening environment based on the economy's strength, the prospect for higher rates and the comeback as a stronger reserve currency. We see particular appreciation potential against the New Zealand dollar and Australian dollar. The major risk at the present stage is that USD is over-owned in the market. • The Japanese yen is undervalued based on purchasing power parity, but the accommodative central bank may keep the currency devalued in the near future. Where we see value is against the euro, where the central bank is also on an easing cycle.

[1] Source: UBS Global Asset Management. As of February 28, 2015.

Market behavior analysis complements valuation

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



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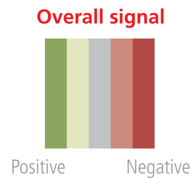
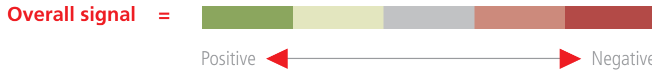
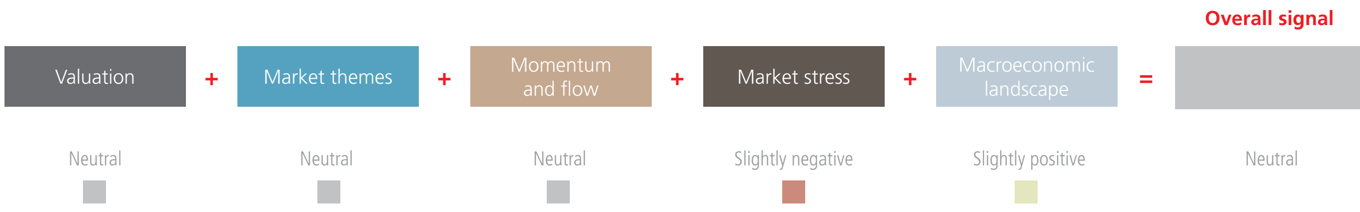


Market themes	Momentum and flow	Market stress	Macroeconomic landscape
Market opportunities that we believe will drive markets in the longer term but have an immediate impact. This helps put valuation into context. For example: "European debt crisis," "aging population" or "deleveraging."	Attempts to capture money flows and market appetite for risky assets from the perspective of professional asset allocators, such as mutual fund managers.	We created a proprietary stress index to help gauge price dislocations and investor risk appetite. It comprises several spread measures across credit markets, currencies and cash markets, as well as measures of market sentiment, such as the Chicago Board Options Exchange Market Volatility Index (VIX).	Understanding the current position (recovery, expansion, slowdown, recession) in the economic cycle of a country or region. We also consider the baseline and alternative economic scenarios of countries and regions, and how asset classes may react differently in these scenarios.

US Equities example as of February 28, 2015

Valuation and market behavior indicators at work

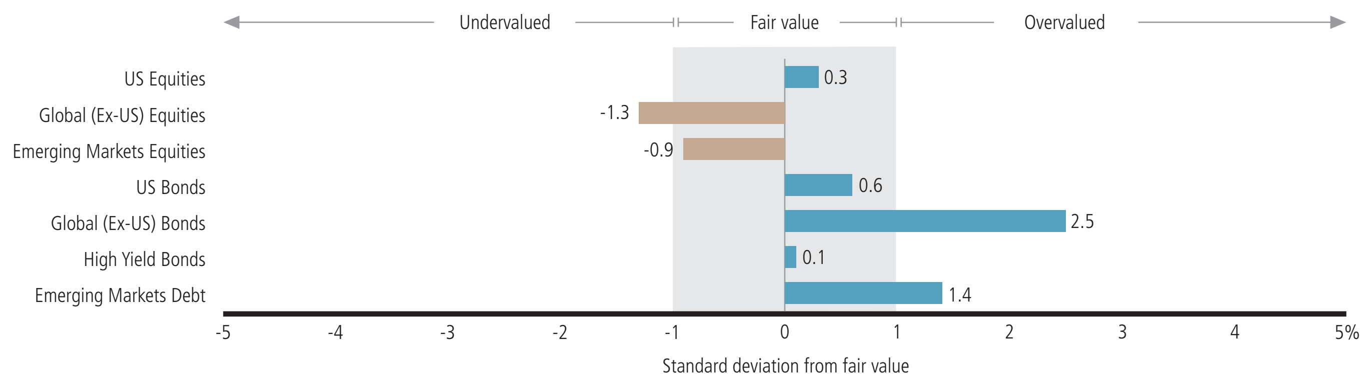




Note: The contribution each component has to the overall signal will vary from month to month.

Normalized asset class valuations[2]

Normalizing the price/value discrepancy provides a standardized relative comparison across asset classes



[2] Based on UBS Global Asset Management's views. As of February 28, 2015.

Definitions of metrics:

1. Asset Class/Benchmark: All investment expectations displayed here are modeled from the discounted cash flows as replicated by the relevant publicly available index. This bears mentioning because these expectations are developed assuming no benefit from active management (i.e. security selection) within the asset classes themselves.

2. Price/Value: An intrinsic value based on the cash flows that an asset class provides—discounted at an appropriate rate of return (the required rate of return)—is identified for each of the asset classes listed. The cash flows would be those that would be expected to pass through to the asset holder; in the case of equities, the relevant cash flows are earnings and nonreinvested earnings (including, though not exclusively, dividends). That intrinsic value is then compared to the market price for the proxy index, and the degree of over- or undervaluation is thereby calculated in percent.

3. Normalized Price/Value: The normalized price/value represents the standard deviation, or dispersion, of the asset class from our estimate of fair value. Normalizing the price/value discrepancy provides a standardized relative comparison across asset classes. The normalized price/value is calculated by taking the price/value of an asset class and dividing it by the secular risk estimate of the same asset class.

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