Panorama

Mid-Year 2017 | UBS Asset Management

The reflation debate

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UBS

Introducing *Panorama: Mid-Year,* in which our senior investors assess the shifts in the global investment backdrop since our December 2016 edition and highlight some of the key opportunities and risks they see over the next six months.

This edition explores:
- Asset class and valuation comparisons across the liquid asset classes
- Views from our investment areas on the key drivers of reflation
- The implications of normalizing monetary policy and geopolitics

The following pages bring you distinct viewpoints, drawn from the full breadth of our global capabilities to help you meet your investment challenges.

For more on our views and forecasts from year-end 2016, please see *Panorama: Investing in 2017,* below. This piece can be found at:

UBS.com/assetmanagement

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Michael Ho
Chief Investment Officer, Investment Solutions

Toward normalization

Highlights

- Elevated levels of economic, policy and geopolitical uncertainty exist globally
- Correlations are falling sharply, both within developed equity markets and at a country level
- EM equities remain attractive, particularly versus stretched US equity valuations
- Robust opportunity set for high conviction active managers to generate alpha

But beneath the surface a more nuanced and multi-layered investment backdrop is emerging.

Since the publication of Panorama's year-end issue in December 2016, the investment backdrop has evolved broadly as forecast. Over the past six months the eight year bull market in global equities has continued apace. Risk assets in general have been supported by expectations for a continued broad-based pick-up in global economic growth, still loose monetary policy conditions and more recently, by strong corporate earnings. European and Emerging Market equities have outperformed as demand and earnings momentum in both regions accelerate. Key developed world benchmark government bond yields are broadly unchanged while volatility across major equity, bond and FX markets has generally stayed very low by historical standards.

But beneath the surface a more nuanced and multi-layered investment backdrop is emerging. With economic policy uncertainty at elevated levels, the drivers of global growth changing and broadening, sector correlations within developed equity markets have fallen sharply. Across equity markets globally, previously strong correlations at the country level are also waning.

A key driver of those falling correlations has been investors' fluctuating views on the outlook for growth and inflation in the US. In markets, those changing views have not been difficult to identify. An initial surge in longer-dated US

With economic policy uncertainty at elevated levels, the drivers of global growth changing and broadening, sector correlations within developed equity markets have fallen sharply.

nominal bond yields in the wake of Donald Trump's election victory was further supported by very strong consumer and business surveys. However, more recent US activity data has been softer than expected and the US yield curve is now back to pre-election levels. Within the US equity market a similar narrative has emerged. A very sharp rotation out of Growth stocks and into long forgotten Value and Cyclical stocks post-election has now reversed—even while equities broadly have continued to rally.

So is the global reflation investment theme over? In this year's *Panorama: Mid-Year* senior members of our investment teams across both traditional and alternative asset classes wade into the reflation debate.

Specifically, we have asked our contributors to identify the risks and opportunities in their respective investment universes in the context of what we see as the three key drivers of markets in the remainder of 2017 and beyond:

1. The theme of reflation

2. The extent to which monetary policy changes have already been priced in by the markets

3. Geopolitical developments globally

In aggregate, the responses highlight the diversity of views around the US growth and inflation narrative—suggesting that market dispersion and therefore the opportunity set for high conviction active managers to generate alpha is likely to stay high.

One interpretation of the differing views on growth and inflation is that the reflation trade is evolving from a synchronized global story to a more complex narrative of individual reflationary cycles each developing at their own speed and with their own opportunity set.

On monetary policy there is a strongly consensual view among our senior investors that the Federal Reserve will raise the Federal Funds rate once more in 2017 in line with current market forecasts. But as a number of our investors detail, perhaps the more

significant question surrounds the unwinding of the Federal Reserve's balance sheet. With 2013's 'Taper Tantrum' acting as a salutary lesson in market sensitivity to perceived shifts in the Fed balance sheet, communication is likely to be key to the market's reaction. In the following chapters, our investors outline the most likely scenarios and their potential impact on key asset classes.

In our December issue of Panorama we noted that both social and economic drivers were likely to result in higher fiscal spending going forward and, as monetary policy is slowly normalized, in a shift from monetary to fiscal policy as the primary growth stimulus.

But while expectations for fiscal stimulus remain high in the US, hard and fast policy progress has been limited to date. In particular, the timing and scale of President Trump's pro-growth policies remains unclear as his domestic agenda is tempered by the realities of deal making in Washington and a slender Senate majority.

Elsewhere, our investors clearly believe that the theme of geopolitics will remain a major influence on markets. Even if Eurozone-break-up risks have dissipated in the short-term in the wake of the French presidential elections, the surprising failure of the ruling Conservative party to secure an outright majority in the recent UK general election shows that the populist movement is far from over.

While expectations for fiscal stimulus remain high in the US, hard and fast policy progress has been limited to date.

Linking geopolitics, the policy backdrop and the reflation trade, the most frequently-cited risk from our investors lies in China. As our Multi Asset team highlight, there are robust arguments that the origins of global reflation lie not in the US, but in the stimulus provided to the Chinese economy in early 2016 and its subsequent boost to commodity prices. In an important year for Chinese politics, the Chinese authorities face a difficult task in rebalancing the economy while reining in the credit bubble without prompting a sharp demand slowdown.

Six months ago we expressed our belief in continued support for global equity markets and for Emerging Market (EM) equities in particular. Looking forward the case for equities more broadly is tempered by recent multiple expansion, but we still see a very strong case for EM equities on a relative basis, particularly versus US equities where valuations appear stretched.

The most strident message from this year's Mid-Year regards the high level of economic, policy and geopolitical uncertainty globally. For markets this may well mean more frequent and more severe bouts of risk aversion than has been the case for most of the post-financial crisis period. But for high conviction active managers, it also means the strongest potential opportunity set for a decade.

Key investment views

Traditional and liquid alternatives: Changing allocations Q4 2016 – Q2 2017

Traditional asset classes: The view from the Asset Allocation team

Over the past six months the biggest change to the Asset Allocation team's core asset class views has been a more **positive stance on nominal US Treasuries**. Core inflation is edging higher in an inconsistent manner but remains muted despite levels of unemployment that have been associated historically with stronger wage growth. However, the Treasury market's initial expectations on the pace and scale of President Trump's change agenda and its impact on US growth and inflation immediately appeared overly optimistic.

Moreover, we expect structural deflationary forces including aging populations to continue to act as a rebalancing mechanism to significant yield rises in the medium term. Ten year US Treasuries now look broadly fair value in a long-term context relative to their own history. But with the majority of other major developed world government bond markets looking very expensive, we now see nominal US Treasuries as offering attractive carry on a relative basis after the rise in yields, particularly versus German bunds.

Our views on global equity markets remain little changed since year end. Our analysis shows the **broader US equity market as overvalued**. The key question is whether the outlook for earnings has increased sufficiently to justify the post-election equity rally. We don't believe they have and estimate US earnings to already be above their cyclically adjusted normal levels. The answer, therefore, would appear to be that US equities are expensive at current levels and with expectations elevated, vulnerable to disappointment.

Outside of the US, we see attractive valuations and the improving growth backdrop as supportive to international equities. In Europe, we continue to believe that the European earnings recovery story is gathering momentum. Initially supported by the European Central Bank's (ECB's) loose policy and a weak euro, with bank balance sheet restructuring now largely over, we see the recovery as increasingly self-sustaining.

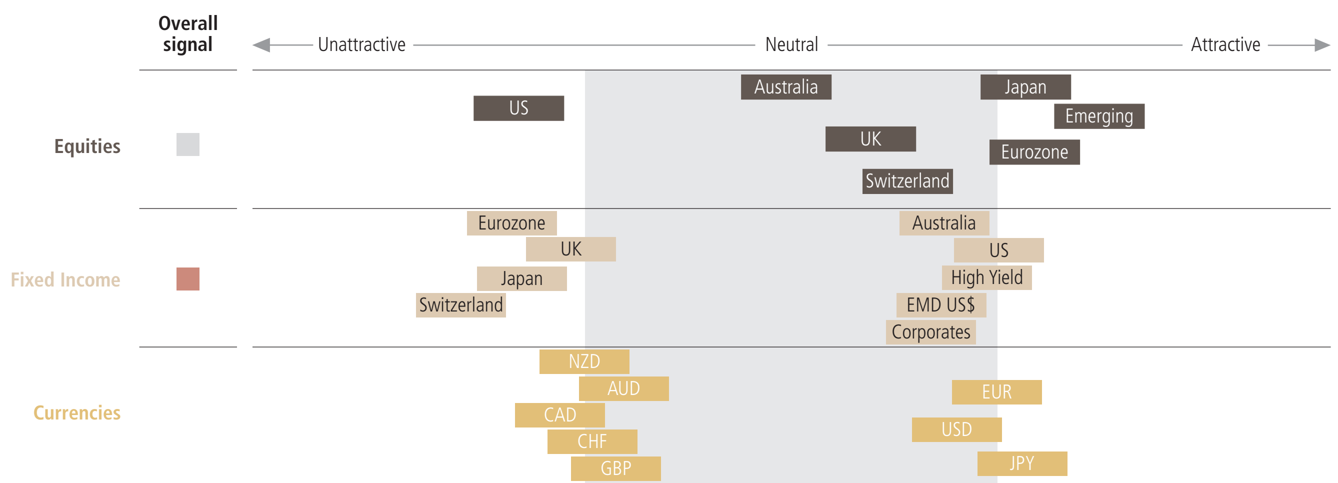
We also continue to view Emerging Market (EM) equities as structurally cheap alongside improving demand and earnings data. And while EM may be the focal point for Trump's trade protectionist rhetoric, US tax cuts and infrastructure spending are likely to benefit EM overall. A sharp China slowdown remains a risk, but we expect continued policy support ahead of October's National Congress.

Overall signal =

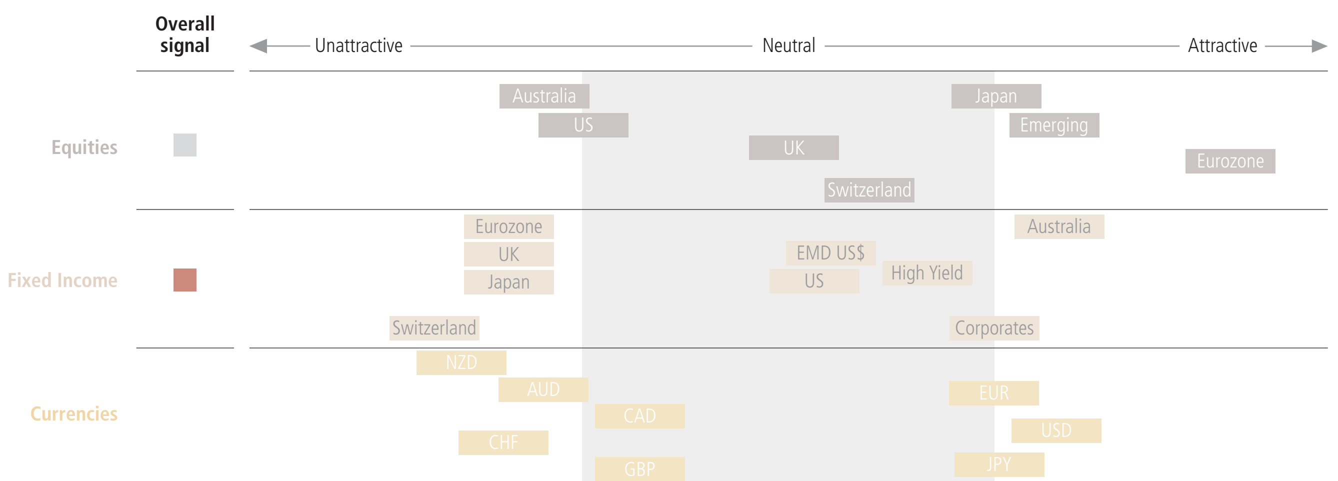
Positive ◄——► Negative

Changes in tactical allocation views

Traditional asset classes, and currencies—as of May 31, 2017[1]



Traditional asset classes, and currencies—as of November 30, 2016[1]



[1] Source: UBS Asset Management's Asset Allocation and Currency team, as of May 31, 2017 and November 30, 2016 respectively. Views are provided on the basis of a 12–18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

Hedge Fund Strategies: The view from UBS Hedge Fund Solutions

In Q2 2017, market optimism following the US presidential election was tempered as President Trump's initial attempts to enact reform met challenges. In Europe, political risks have temporarily subsided following the French presidential election and capital flows into the region have notably increased. However, populist sentiment and divergent political policies still pose a risk to the future of the Eurozone.

In Equity Hedged, UBS Hedge Fund Solutions (HFS) reduced exposure to opportunistic trading approaches in favor of more concentrated fundamental and event-driven strategies. While confidence in President Trump's pro-growth agenda has faded somewhat, HFS believes that fundamental approaches will still be supported by expectations for economic growth and asset reflation. Pro-growth reform may also result in increased Mergers & Acquisitions (M&A) and corporate activity, benefiting equity event approaches. Opportunistic trading approaches still exhibit factor and position crowding and may be susceptible to industry unwinds. HFS continues to diversify through European and Asian strategies given improved regional outlooks.

In Credit / Income, HFS' exposure to corporate credit is at historically low levels and we are focused on idiosyncratic co-investments that offer positive asymmetry. HFS' core exposure is focused on legacy residential mortgage backed securities in Asset Backed strategies and Reinsurance, which continues to provide uncorrelated returns.

HFS has increased allocations to Relative Value approaches, as the lack of competition from the sell-side opens up opportunities for fund-of-funds. Fixed Income Relative Value remains a high conviction strategy due to improved interest rate, spread and curve volatility. In Merger Arbitrage, despite mid-single digit median Internal Rates of Return (IRRs), hedge funds have been able to take advantage of spread volatility and less crowded conditions. Global M&A volumes persist and offer a decent backdrop for arbitrage opportunities. HFS is less optimistic on convertible bond arbitrage and Agency Mortgage Backed Securities given tight credit spreads, low volatility and low-option adjusted spreads.

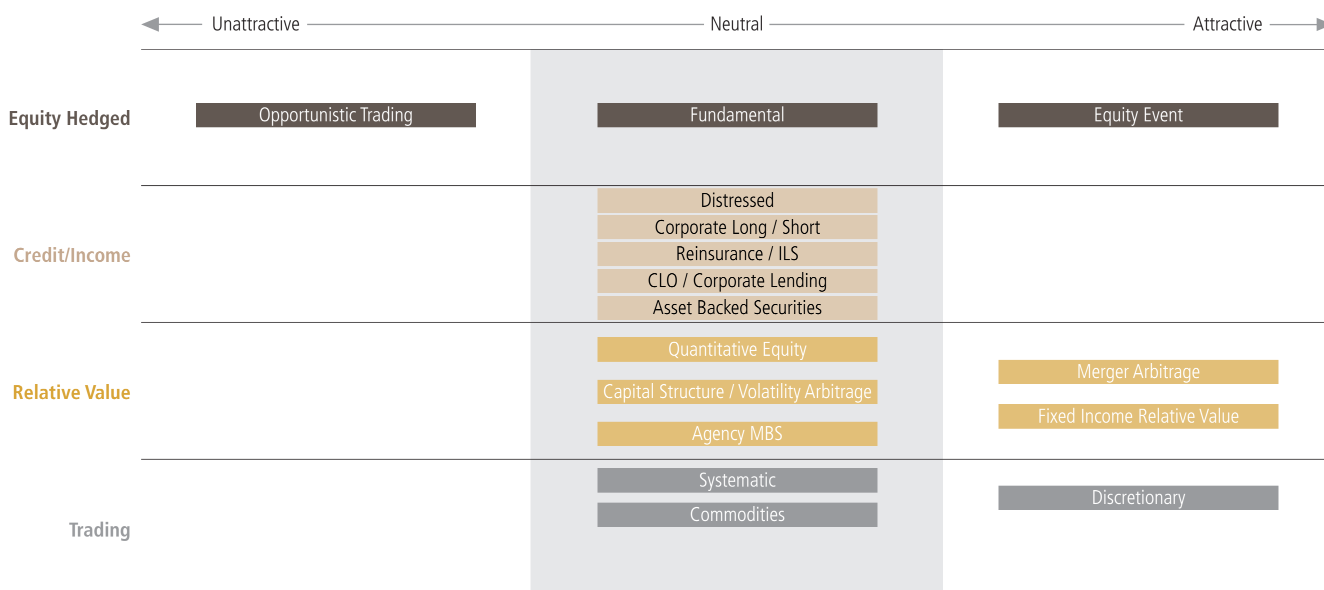
HFS has made modest allocation increases to trading strategies as we await an increase in volatility or a shift in global monetary policy to spark better trading opportunities. HFS has also increased allocations to Systematic CTA strategies; while models may struggle to capture unanticipated policy events, HFS expects clearer trends to emerge given shifting monetary policies and macroeconomic dynamics. HFS has reduced commodity allocations; while we believe there are attractive opportunities, particularly in Relative Value, managers have been challenged by technical market dynamics. Quantitative strategies remain mired in a competitive backdrop and the need to select top tier managers is paramount.

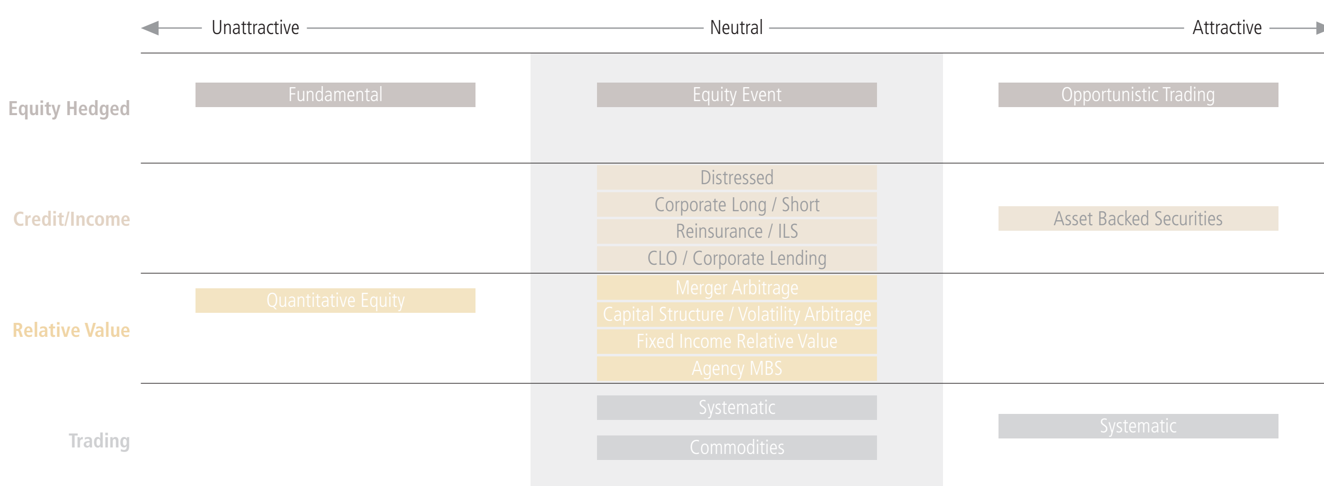
We are increasingly concerned of a tail event building as a result of crowding into new strategies such as risk premia and commodity trading advisors (CTA). HFS believes that continued volatility compression and long equity exposure could make these areas susceptible to a volatility shock and cause a notable selloff in equity markets as those observed during the 1987 flash crash.

Overall signal =

Positive ◄——► Negative

Changes in tactical allocation views





[1] Source: UBS Asset Management's Hedge Fund team, as of March 31, 2017 and September 30, 2016 respectively. Views are provided on the basis of a 12–18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

Reflation

What are the risks and opportunities with regard to the growth and inflation outlook?

The nuanced nature of the investment landscape is clearly demonstrated by the range of views expressed across our investment teams. While there is a broad agreement that the narrative is shifting towards one of gradual reflation, the degree of that shift and its implications on the opportunity set are very much market-specific.

Emerging Markets Equity

Geoffrey Wong, Head of Global Emerging Markets & Asia Pacific Equities

As evidenced by an array of improving economic and corporate indicators, Emerging Markets broadly, and Asia in particular, seem to be at the early stages of an economic expansion. After several years of declining capital expenditure, the return of rising capital investment should be a key driver of reflation within the region.

The reflation story has already played out well in China over the past year, boosting asset prices and corporate profitability. In doing so, it has reduced risks related to non-performing loans in the banking system.

Emerging Market demand tends to be positively correlated to global growth, reflecting the fact that improving global demand is typically accompanied by rising commodity prices. Commodity exports are a significant part of many EM economies, particularly outside Asia.

Our analysis of Emerging Market equities' sensitivity to developed world rates and demand growth supports this view. Over the period 2003-2016, that analysis shows, on average, Emerging Market equities performing well in months where US rates (as measured by the five-year rate) were increasing and developed world growth was improving (as measured by the Developed World Purchasing Managers Index). Conversely, in months where US rates were increasing but developed world growth was deteriorating, on average Emerging Market equities did not do too well.

US Equities

Tom Digenan, Head of US Intrinsic Value Equity

Following the US presidential election, the reflation trade was clearly on. Expectations of lower taxes, less regulation and increased fiscal spending swamped concerns over trade policy. That trade has since turned. Expectations for a pickup in economic growth have, to date, exceeded reality. While soft data, surveys and opinion polls, are showing much stronger readings, the hard data—US GDP growth—remains muted. Demand pickup could still come to fruition. The first quarter GDP growth over the last seven years has been less than half that experienced during the rest of the year. If we truly are in a reflationary regime, we will see a pickup in the hard data as we move forward. One of the drivers of inflation, real wage growth, remains muted. This is despite low unemployment numbers. However, it has also been impacted by low labor participation and increased automation. To the extent that pro-growth policies get delayed, or never occur due to self-inflicted political problems, that would slow the expected economic tailwinds investors are hoping for.

Fixed Income

Anne Anderson, Head of Fixed Income Australia

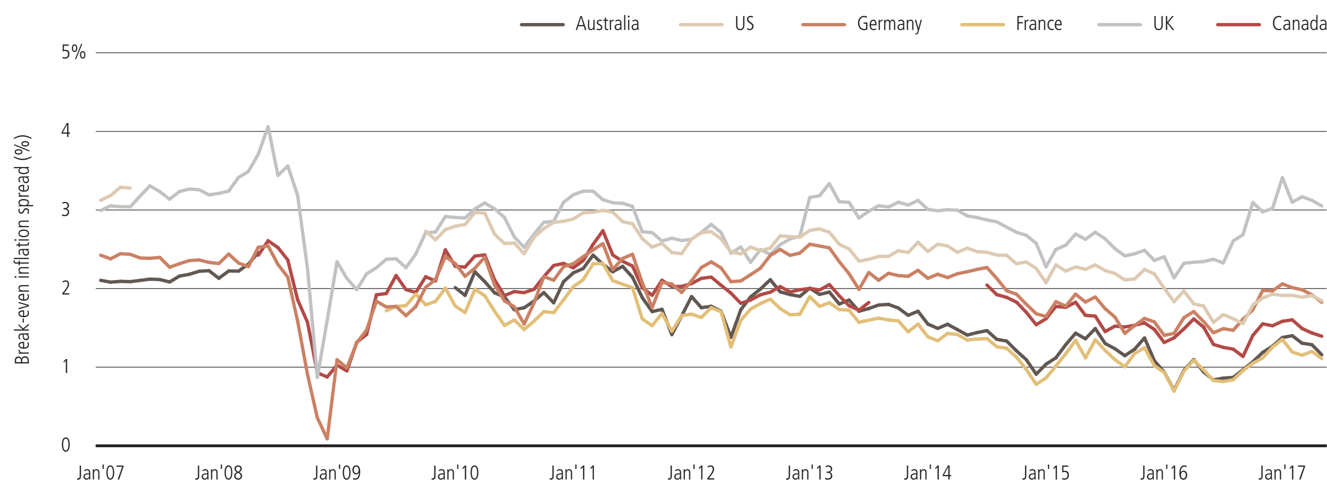
The global cyclical recovery has broadened. We think growth momentum will be sustained but will not accelerate from here.

The rise of populism will, we believe, ultimately result in support to demand from fiscal policy. However, execution risk creates its own set of uncertainties. Monetary policy remains deliberately accommodative while core inflation remains below central bank targets. Market pricing of 10-year forward inflation expectations has cycled higher as commodity price weakness has annualized. Notably however, pricing expectations in major developed economies do not foreshadow any meaningful rise in future inflation, except in the UK, where a weak pound and Brexit uncertainty are supporting higher expectations.

Over time, we think market pricing of inflation may prove too low. However, near-term risks are tempered by weak wage growth and a softening in commodity prices. We continue to see secular forces at work including demographics, deleveraging and excess capacity that keep core inflation in check.

We expect Emerging Markets to continue to perform well. In China, producer price inflation appears to be moderating, in turn alleviating downward pressure on consumption at a time when policy makers are already slowing the unsustainable growth in leverage. A gentler landing in China as it rebalances its economy would be a positive global development that helps sustain growth and underpins our gradual reflation view. However, there are clearly risks of a more abrupt China slowdown as tightening in credit conditions triggers a sharper deleveraging cycle.

10-year breakeven inflation measures



Source: Bloomberg.

Asset Allocation

Jonathan Davies, Ad Interim Head of Asset Allocation,
Investment Solutions

Despite extremely low interest rates and falling unemployment levels, inflation indicators remain highly subdued in the developed world. Traditional macroeconomic theory assumes inflation rises when resources, including the supply of labor, start to become scarce. Nevertheless, unemployment levels have already fallen below levels that were previously estimated to be associated with rising inflation. Furthermore, monetary policy seems to have had far less of a stimulatory effect than expected.

This does not necessarily imply the traditional framework is wrong. It may be that the underlying economic parameters have shifted. Globalization, demographic shifts and the impact of disruptive technology could mean there is scope to use existing resources far more intensively before any inflationary pressures arise.[1] This would mean unemployment has to fall further and stay low for longer before inflation starts to rise meaningfully.

An alternative view is that the severity of the shock caused by the global financial crisis resulted in a prolonged, but ultimately temporary, disruption of economic relationships.

Based on either of these views, reflation would seem to be a matter of when and not if.

Multi Asset

Phil Brides, Co-head of Portfolio Management, Investment Solutions
Nathan Shetty, Co-head of Portfolio Management, Investment Solutions

With recent growth and inflation-related data mixed, the reflation theme has played out inconsistently across different asset classes over the last six months. As US upside economic surprises retreat, and the equities of traditional reflation beneficiaries underperform, some are even suggesting that the reflation trade has already peaked, at least in the US.

Going forward we believe the seemingly synchronous reflation we have seen globally will be replaced by differentiated reflation cycles. Against this backdrop we see the main opportunities in equity markets lying outside the US.

This reflects our view that expectations for fiscal stimulus are already high in the US; greater scope exists for disappointment in stretched US equity valuations; and that the US is already in a mature stage of the business cycle. Meanwhile, Europe and Japan in particular are at an earlier stage of their recoveries and benefitting from lower rates at a time when conditions in the US are already tightening, albeit slowly.

However, while we see the backdrop as supportive to both emerging and developed equity markets ex-US, we would caution that a high level of complacency exists among investors. And while there is evidence of some reflationary trends, it is too early to declare the death of 'lower for longer', given ageing populations, high debt levels and de-globalization.

We also see China as a key risk. There are good arguments that the real origins of global reflation lie not with President Trump but in the Chinese construction boom and its support to commodity prices. As a more aggressive tightening of financial conditions is adopted, that support may now reverse. We see the speed of adjustment in China as key. The imbalances need addressing, but any sudden move in the CNY, Shibor and overall debt levels could be taken as a sign that the authorities are losing control of the process.

[1] Some economists are postulating that current measures of inflation, despite their very low levels, are actually overstated. This is based on the theory that the most commonly used methodology for calculating inflation—based on so-called hedonic price adjustments—does not adequately take into account improvements in modern technology such as laptops and mobile phones.

Hedge Fund Solutions

Bruce Amlicke, Chief Investment Officer & Head of Multi-Manager
UBS Hedge Fund Solutions

Within UBS Hedge Fund Solutions, we believe the reflation theme remains intact, not just as a US phenomenon, but globally. Chinese stimulus has been providing tailwinds, including in Emerging Markets, and has been under-appreciated by market participants until recently. In the Eurozone, growth should continue with less political risk following the French presidential elections. While uncertainty remains regarding follow-through on US reform, pro-growth policy proposals have been set out.

O'Connor

Erin Browne, Managing Director & Portfolio Manager, O'Connor
Kevin Russell, Chief Investment Officer, O'Connor

Some of the initial sparks of global reflation are fading, but underlying drivers exist, which are picking up the slack. Of the former, the positive year-over-year contribution from 2016's oil price rebound is falling out of annual headline inflation figures and China's fiscally driven growth is now being tempered.

Where do we see strengthening drivers? We believe the US economy is set to rebound sharply from its habitual first-quarter seasonal softness. Business investment is showing signs of life and fiscal stimulus could offer additional upside in 2018, easing some of the burden on consumption as the sole driver of US growth. European, Japanese and UK activity are also showing resilience, supporting the synchronous nature of the global recovery. As above-trend growth continues, it is likely that output gaps will close and more durable core inflation will take hold.

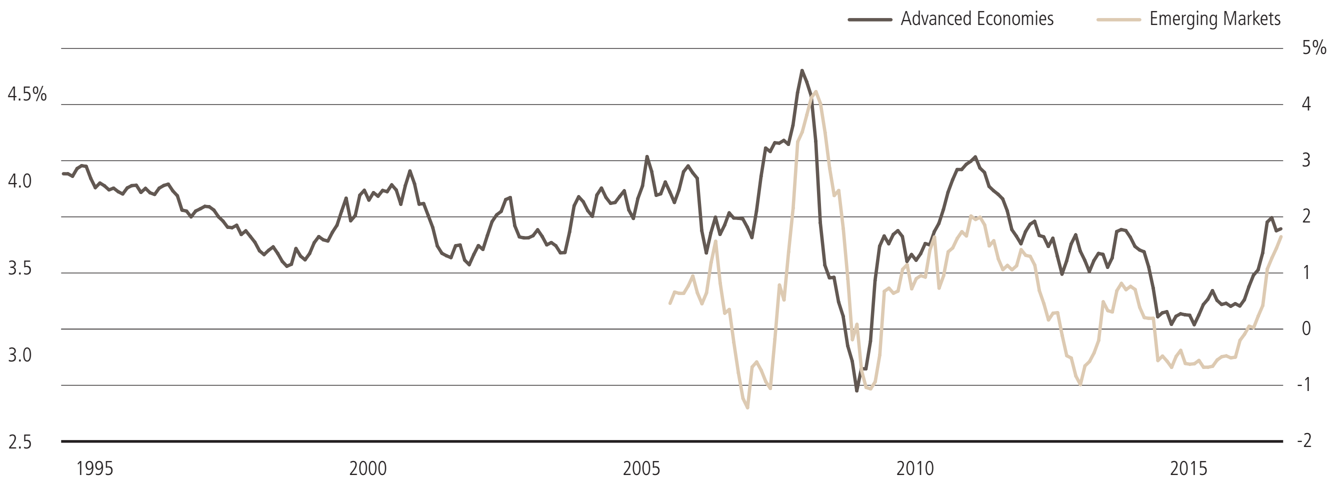
The US is clearly most advanced in this process: labor markets are tightening and wages rising. But as long as other developed economies continue to heal, markets will enjoy a steadier global reflation.

As the backdrop of improving global growth and inflation becomes more firmly entrenched, we expect investors to shift away from low-yielding developed market bonds and bond proxy equities into higher returning assets, including growth and high beta equities.

Within equities, the more cyclically-oriented sectors that are sensitive to rising inflation expectations should benefit most. Even though investors began building reflationary positions in late 2016, many of these positions have since been unwound. Consequently, entry points look attractive.

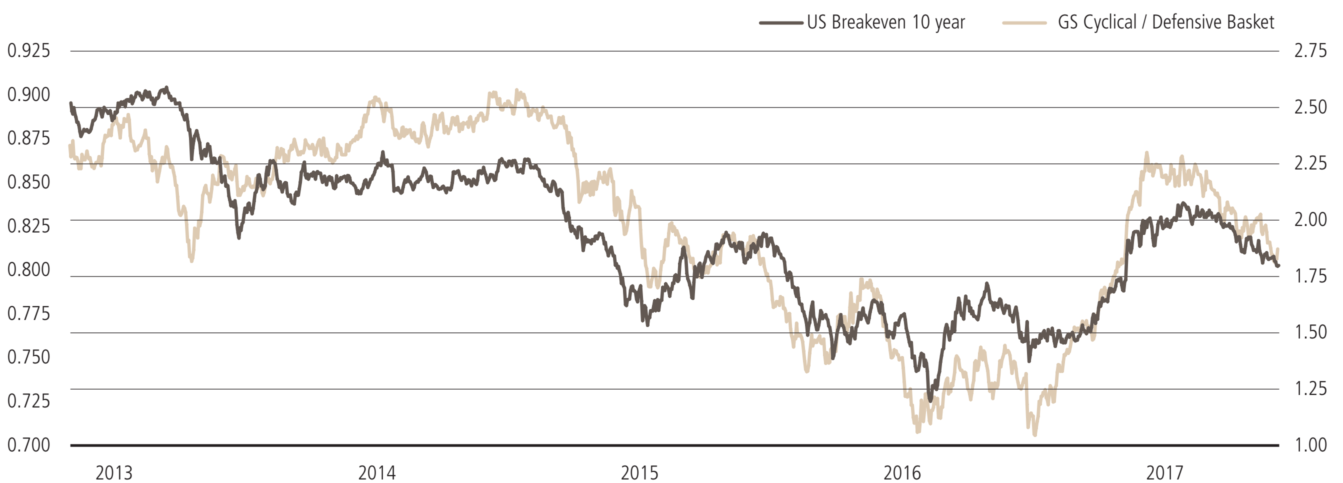
O'Connor (continued)

Advanced vs. Emerging CPI Growth



Source: UBS O'Connor, Macrobond.

Inflation Breakevens vs. Cyclical/Defensive Equities



Source: UBS O'Connor, Macrobond.

Real Estate

Paul Guest, Lead Real Estate Strategist

A number of factors now co-exist in the global economy in a way that has not been seen since the global financial crisis, notably: energy price growth (due to base effects), Chinese producer price inflation, some wage inflation through tight labor markets, and accelerating liquid money supply growth. Some can easily reverse but others are stickier and will endure. On balance, the combination should lead to higher inflation than has been the norm for the past few years.

Real estate is often perceived to have inflation-protection characteristics. This largely reflects the belief that in a rising inflation environment, good quality, well-located, well-managed property should provide protection through rental growth. However, there are no guarantees of protection from rising prices. Given this type of real estate is already what everyone wants, it is expensive.

Nonetheless, property does offer more explicit ways to obtain real value in a higher inflation world. For example, so-called long-income assets (15+ year leases to blue chip companies), or leases with fixed or inflation-linked uplifts. Although not universal, these are common in certain countries and sectors. These products are attractive, but are already expensive and so require careful evaluation.

A third area of potential focus in an inflationary environment is niche property where demand, and therefore rent, is growing faster than the overall economy. Segments include medical office, student housing, high-tech warehouses, self-storage and a few others. Such sectors are smaller, harder to access, and expensive also. Consequently, they require the same careful evaluation as long-income assets.

Private Markets

Markus Benzler, Head of Multi-Managers, Private Equity

Private Equity (PE) has been on a strong growth-driven run since 2011 with PE fundraising reaching USD 589bn globally in 2016 (Source: Bain & Company, Inc.) which was only 2% below 2015. In addition, there was a rise in megafunds with 11 managers raising more than USD 5bn each and USD 90bn in total. On the investments front, capital deployment into investments was also buoyed by continued strong availability of leverage and ample dry powder (accordingly, US leveraged buyout valuations rose to 10x Ebitda in the US and Europe; Source: Standard & Poors LCD).

In a reflationary environment (and coupled with higher interest rates), fund managers will expect some outflows from the asset class to credit and fixed income. This will be mitigated by demand from the queue of new investors who have been waiting for access to their funds. On the investments front, the softening of exit markets since 2014 would continue with IPOs falling in number and value. Mitigants would be financial buyers with their high dry powder and strategic investors filling the shortfall. On the flip-side, new investments would be made based on more conservative lending and growth and more modest consumption rate estimates creating more level-headed acquisition markets.

Monetary policy

To what extent have likely monetary policy changes already been priced in to markets? What are the risks and opportunities?

Our investors are clearly agreed on the direction of monetary policy. The Fed will likely hike once more before the year end, while the ECB is expected to move towards policy normalization later this year. Past 2017, the outlook is less clear. While central banks appear to have learnt from the 2013 'taper tantrum', several of our investors see a faster than expected tightening as one of the key risks.

Emerging Markets Equity

Geoffrey Wong, Head of Global Emerging Markets & Asia Pacific Equities

Not only is the monetary cycle in Emerging Markets more decoupled from the US than in the past, it is also a highly heterogeneous picture across the various EM countries. On the one hand, in countries like Brazil, Russia and India we expect interest rates to decline from their high levels, while on the other, we expect greater correlation with the US rate cycle in countries like China and Mexico, and with European rates in the central European countries of Poland, Czech Republic and Hungary.

Although it is difficult to say to what extent US monetary policy changes have been priced into EM/Asia markets, previous episodes of US Fed rate hikes have shown no discernible correlation with EM/Asia equity market performance, unless the rate hikes were a surprise. Surprises are certainly unlikely at present. US rate hikes have been discussed and expected by the markets for some years and the hiking cycle has already begun. Nonetheless, a faster than expected pace of rate hikes still has the potential to negatively surprise markets.

The other point to note in this regard is that the external debt situation (both net and gross) for EM is much improved from the late 1990s and early 2000s. The vulnerability of EM to rising rates is therefore significantly lower.

US Equities

Tom Digenan, Head of US Intrinsic Value Equity

Monetary easing appears to have ended, but accommodative monetary policy has not. The 'lower for longer' policy of the Fed still has some more room to run. While the direction for short-term rates is up, the slope is not steep—we have not seen an adjustment in the long end of the yield curve. Long-term rates in the US remain muted and are more tied to interpretations of economic data than the Fed's decisions around short-term rates. As far as Fed policy and its impact on US equity markets, it is important that investors note the recent market strength may be attributed to a rise in corporate profits. An increase in the speed and slope of rate rises would most likely generate a negative reaction from investors. We would not expect this to be the path followed by the Fed unless we were to see a much sharper pickup in real wage growth, which as yet we have not witnessed.

Fixed Income

Anne Anderson, Head of Fixed Income Australia

We expect one more 25 basis point tightening in the key US Federal Funds rate before the end of 2017. The approach to the Fed balance sheet will be a key theme and given the size of the Fed balance sheet and sensitivity to tightening we believe the unwinding will be gradual. It could possibly take up to five years. The transparency of Fed communication will play an important role in guiding market expectations and avoiding the bond 'taper tantrum' we saw in 2013. One risk into 2018 is the changing composition of the Federal Reserve board of governors—including the chair. Ultimately, we believe that over time, these factors will at the margin increase the US Treasury term premium from current market pricing.

Towards the end of the year, the ECB is also likely to shift the tone of their communication around the current asset purchase program and the emergency levels of the ECB deposit rate. We see a very gradual cyclical lift in the term structure of European rates.

Credit markets continue to be supported by the cyclical recovery and benign monetary policy backdrop. This view is balanced by the maturing credit cycle, particularly in the US, while in Europe an end to the ECB corporate bond purchase program will remove a key influence on credit spreads.

We see value in short duration high yield strategies that provide attractive running yields with lower interest rate volatility and greater visibility on credit quality.

Asset Allocation

Jonathan Davies, Ad Interim Head of Asset Allocation,
Investment Solutions

Taken at face value, sovereign bond yield curves would appear to be pricing in a balance between two divergent narratives: the view that we are in a new prolonged near-zero interest rate paradigm—and the view that interest rates will slowly start to normalize.

In the absence of a radical change in our monetary system, such as the move to a cashless society, the likelihood that interest rates will fall much below zero seems limited. This implies that there is an upside skew to the distribution of interest rate surprises.

The upside tail risk to rates may have been enhanced by risk premia suppression since the financial crisis. After an extended period of ultra-low interest rates, many investors have been forced to stretch for yield, suppressing the long ends of yield curves. Quantitative easing may have further flattened yield curves.

Faster-than-expected policy tightening could be disruptive for bonds and other assets with bond-like returns such as real estate.

Multi Asset

Phil Brides, Co-head of Portfolio Management, Investment Solutions
Nathan Shetty, Co-head of Portfolio Management, Investment Solutions

Overall, markets are more accepting of the reduction of monetary stimulus, due in part to expectations that fiscal stimulus can step into the breach. In the US particularly, the degree of optimism surrounding fiscal stimulus may prove misplaced. In each major region we see the main risk from monetary policy as one of expectations, namely, if investor concerns about inflation should jump significantly. In terms of actual policy action, we expect the rate normalization process to be gradual, precisely because central banks are cognizant of the risks of tightening too rapidly.

That aside, there are risks that political sensitivity to inflation increases, as it would, for example, with a change in Federal Reserve chair, or an increase in German influence at the European Central Bank.

We also believe there is potential for the overall risk environment to shift. Investors have enjoyed a protracted period of very low volatility across asset classes and currency markets. We believe this, at least in part, reflects the impact of low rates and high liquidity delivered via quantitative easing programs. As that liquidity is withdrawn and financial conditions tighten, we would expect volatility to rise, given the high degree of policy uncertainty worldwide.

Finally, if fiscal policy fails to take on the mantle of growth driver, we ought not to dismiss the potential for central banks to revisit monetary stimulus should growth slow meaningfully.

Hedge Fund Solutions

Bruce Amlicke, Chief Investment Officer & Head of Multi-Manager
UBS Hedge Fund Solutions

Overall, regarding US policy, the hedge fund manager positioning we observe has become more muted, reflecting more modest expectations. Long USD positioning appears to be down to its lowest levels YTD, and the market is trading somewhat neutral in duration (after many discretionary traders generated losses YTD from short rates and long USD). In contrast, some commodity trading advisors (CTAs) may be long fixed income and rates.

However, in Europe, positioning is quite different, given broader speculation of ECB tapering or a deposit rate hike occurring earlier than anticipated. It is difficult to gauge consensus views, as managers have taken disparate approaches. However, it's worth noting that in March and April, both the Federal Reserve and ECB were relatively dovish in their interest rate dot plots and inflation forecasts. HFS believes market pricing is now in-line with their dovishness, but we could see hawkish rhetoric going forward, particularly from the ECB.

O’Connor

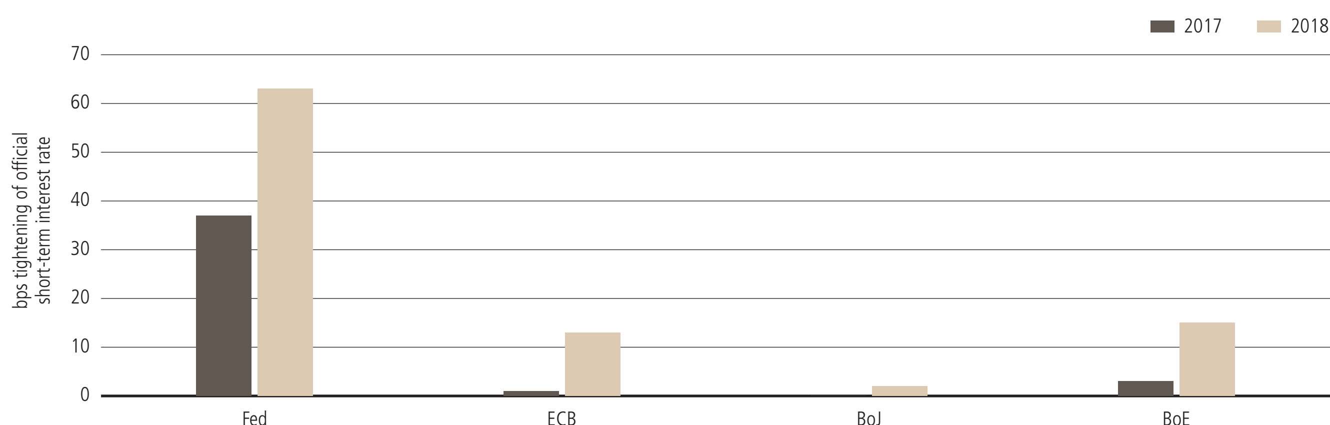
Erin Browne, Managing Director & Portfolio Manager, O’Connor
Kevin Russell, Chief Investment Officer, O’Connor

With US labor markets continuing to tighten and core inflation trending higher, the US Federal Reserve is likely to follow through on its plan to hike a total of three times this year and announce the process for unwinding its balance sheet in December. In Europe, the ECB will likely announce a tapering of its asset purchases later this year before raising its deposit rate. Both scenarios are widely discounted in markets.

While rates markets have recently come closer to pricing in policy normalization, there is still considerable room for higher rates across global curves. In our view, markets continue to under-price Fed rate forecasts beyond 2017. And although there is considerable uncertainty about the pace at which the Fed and ECB will remove accommodation, there is little question that the net supply of bonds in the market will rise substantially in 2018, particularly if Congress agrees to fiscal stimulus.

We think central bankers have learned the lessons of the 2013 ‘taper tantrum’ and will carefully and methodically communicate key policy adjustments to markets. As such, our base case is for a benign increase in US yields which does not undermine equities, as in late 2016. We believe such developments would be positive for developed market bank stocks, leading cyclicals to outperform defensives. Nonethe-less, given unprecedented shifts in global balance sheets, we are mindful of policy error risks which would drive up volatility and undermine risk appetite.

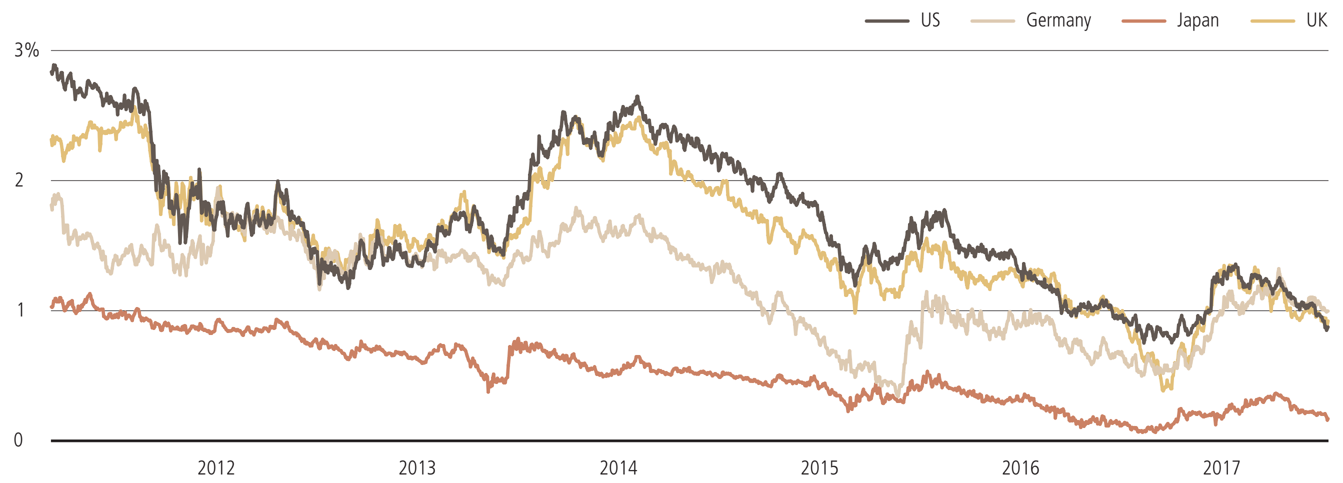
What is priced in to Global Fixed Income markets?



Source: UBS O’Connor, Macrobond.

O'Connor (continued)

Global Yield Curves (2s10s Curve Steepness)



Source: UBS O'Connor, Macrobond.

Real Estate

Paul Guest, Lead Real Estate Strategist

In relative terms, property has been a high yielding asset class in a low yielding world. Consequently, private equity fundraising and transaction volumes both equaled their 2007 peaks in 2015, before easing back slightly last year and continuing to decelerate this year. Property yields have steadily compressed such that, in most markets, they are below the level of the previous boom. By this metric real estate is expensive relative to its own history, even if it remains attractive relative to many other asset classes.

The key question going forward is whether rising interest rates will narrow the risk premium, therefore placing upward pressure on property yields and downward pressure on property values. The current cycle displays a number of features which mitigate this risk: leverage levels are much lower than they were last cycle; prices for lower quality property have not inflated nearly as much relative to good quality property; and most importantly, the spread between base rates and property yields is, in most markets, equal to or above its long-term average.

As it stands, the anticipated gradual rise in interest rates is sufficiently priced into real estate markets. Rent growth driven by strengthening demand will, we believe, be sufficient to offset the small rise in the risk premium. Should a central bank tighten excessively fast or should there an upside inflation shock, we could see more severe downward pressure on values.

Private Markets

Markus Benzler, Head of Multi-Managers, Private Equity

Global PE investors will be looking to the US as a bell-weather for fiscal policy and political impact on PE. So far the US change in administration and the hike in the Fed Funds rate in December 2016 have not led to a trigger for a downturn. But PE investors will remain watchful and note contributory factors such as a further slump of Energy / Commodity markets, an acyclical increase in corporate debt defaults or the effect of a softening of US consumer spending on the backbone of US PE in the middle market.

Geopolitics

Global geopolitical developments and possible consequences

Geopolitical risk remains high on the agenda for our investors, albeit pressures within the Eurozone have eased somewhat, at least short-term. Longer-term, uncertainties remain, particularly given the prospect of an Italian election early by 2018. The focus now has shifted firmly to Northeast Asia, where tensions between North Korea and the US, together with its Asian allies, remain elevated.

Emerging Markets Equity

Geoffrey Wong, Head of Global Emerging Markets & Asia Pacific Equities

In Emerging Markets geopolitical tensions are high in Northeast Asia due to the increasing belligerence of North Korea towards the US and South Korea. But tensions are not limited to those three key protagonists. In particular, the deployment in South Korea of a US-made anti-missile system has angered China amidst claims that the system could be used to better track China's missiles. We believe these tensions will dissipate over time. Nonetheless, even though North Korea's threatened actions have a low probability of materializing, the consequences could be very negative on a number of levels for risk assets broadly, and Asian Emerging Markets in particular.

Elsewhere, geopolitical risks in Russia have also stabilized. While we regard the risks of further sanctions against Russia from the US or EU as low, the chances of lifting sanctions also seem somewhat limited in the short term.

US Equities

Tom Digenan, Head of US Intrinsic Value Equity

We live in a world of constant geopolitical uncertainty. That is not going to change. The election of Donald Trump appears to have increased that dimension significantly, while adding uncertainty to the global geopolitical environment. While we cannot predict what direction this uncertainty will take us, we are cognizant of the risks on the geopolitical horizon. In addition to increased volatility around US trade relations, low oil prices have added to economic instability in the Middle East region. Meanwhile, North Korea continues to act with increased aggression. Within Europe, concerns around the European Union abated following the French election, but they have not achieved the stability investors would prefer. We will continue to look for pricing opportunities offered by these uncertainties.

Fixed Income

Anne Anderson, Head of Fixed Income Australia

The rise of populism across the developed world will continue to challenge investors to anticipate and price the dimension of risk. The notion of acute extremism may have receded in the short term in Europe but around the world the electorate's 'anti-establishment' tone has been recognized by politicians across the spectrum. As politicians weave their narrative, they create uncertainty and even crisis situations.

There is therefore a lack of clarity around policy intent at the present time as the new style of politics bumps up against the traditional checks and balances. Trade arrangements will be impacted as new global political relationships are negotiated by, for example, the US and the UK.

In the US, the execution of Trump's policy agenda will continue to be slowed by domestic political constraints and temper reflation expectations.

Internationally, Trump's confrontational stance with China has moderated—an approach that serves both parties, at least for now—but how the protectionism narrative evolves will be very important going forward for the global macro picture.

Asset Allocation

Jonathan Davies, Ad Interim Head of Asset Allocation, Investment Solutions

Two geopolitical themes to watch going forward are:

1. **the erosion of support for mainstream political parties and policies and,**

2. **possible on-going erosion of support for globalization.**

On the surface, European elections this year appear, so far, to have bucked the trend of rising support for non-traditional policies. Nevertheless, the recent election of Macron as president of France was consistent with the view of rising support for non-mainstream policies. The surprise gains made by the Labour Party on a manifesto of left-leaning populism in the UK's recent general election reinforce the point. We may thus be in an era of greater policy uncertainty than has been the case for the past two to three decades.

Multi Asset

Phil Brides, Co-head of Portfolio Management, Investment Solutions
Nathan Shetty, Co-head of Portfolio Management, Investment Solutions

Italian elections are a big hurdle to overcome for the EU, given the strength of Italy's populist movement. But assuming no surprises in 2017's remaining European elections, we think it likely there will be a gradual reduction in European geopolitical risk premia. This suggests the spread between peripheral European bond yields and German bunds will close and that European risk assets more broadly shouldn't be discounted based on increased political risk going forward. We see this as supportive for all European assets but particularly equities, credit and EUR as political tail risks fail to materialize.

The theme of de-globalization remains very real and any increase in protectionism/import tariffs simply raises prices but slows trade globally. We would highlight as material the renegotiation risks for Canada in particular in NAFTA. The big question for the global economy is whether the process of globalization has been the key contributor to global growth and if so, whether the changing political landscape and rise in protectionist sensibilities now places this at risk.

Hedge Fund Solutions

Bruce Amlicke, Chief Investment Officer & Head of Multi-Manager
UBS Hedge Fund Solutions

Following the French presidential election, corporate management has more clarity and confidence in executing business plans. As such, HFS expects an increase in European corporate activity, potentially offering more attractive opportunities relative to the US. We currently prefer European Event and Equity Hedged strategies, which should perform well during risk-on environments.

However, other geopolitical risks remain in the periphery and can continue to create market volatility. North Korean escalation, Syrian missile strikes and the Middle Eastern region generally continue to demonstrate the markets' vulnerability to surprises. As a barbell in the event of increased volatility, we believe Fixed Income Relative Value (FIRV) strategies offer compelling opportunities especially in EUR-related strategies, including cash-futures basis trading and various curve constructions.

O'Connor

Erin Browne, Managing Director & Portfolio Manager, O'Connor
Kevin Russell, Chief Investment Officer, O'Connor

Global geopolitical risks have eased considerably over the course of the year, although they remain on investors' radar. In the US, fears of significantly increased protectionism have dissipated. Contrary to campaign statements, the Trump administration decided not to label China a currency manipulator, nor did it take steps to withdraw from NAFTA, its trade agreement with Canada and Mexico.

In Europe, the victory of centrist Emmanuel Macron in the French presidential election has removed immediate existential risks to the Eurozone while increasing the prospects of a stronger EU 'core' alongside Germany. And while the UK election did not quite go as planned for Prime Minister May and the Conservative Party, the new government is more likely to go the route of a 'soft Brexit' which emphasizes trading ties and does less damage to the UK economy.

Despite these positive developments, geopolitical risks remain. Tensions between North Korea and the US and its Asian allies have escalated in recent months. In Italy, where populist and anti-EU parties have stronger support, an election looms large in early 2018.

While we don't expect geopolitical development to overshadow the positive narrative for risk assets, we do expect intermittent periods of tension to add volatility to markets over defined periods.

Real Estate

Paul Guest, Lead Real Estate Strategist

Political uncertainty has been a major source of speculation and concern for property investors. Short term, the electoral cycle or other geopolitical events can have a tangential effect through uncertainty and delays in decision making, or prompt a tenant to alter their needs. Across a market, this can affect vacancy rates and rents, or investment activity and therefore values. But these are hard-to-measure indirect, sentiment-driven effects.

Longer-term, the impact of geopolitical events can be significant for property. Take, for example, the UK's referendum on EU membership and the likely impact on banking regulation. This could have negative consequences for financial sector occupiers in London. Alternatively, the potential influence of French President Macron's economic reforms could impact employment and tenants' demand for space. However, such changes can take several years to materialize and, unlike more liquid asset classes, are only very gradually priced into direct real estate values.

About the authors

Bruce Amlicke is a Chief Investment Officer & Head of Multi-Manager UBS Hedge Fund Solutions. His primary role is the creation of a center of excellence for the selection of third-party alpha managers across traditional and hedge fund capabilities. Bruce re-joined UBS in 2010, having spent five years as CIO of Blackstone Alternative Asset Management and Senior Managing Director of The Blackstone Group. Prior to that, Bruce was CIO of the then O'Connor Multi-Manager Program from 2003–2004—a predecessor business to HFS. He originally joined the O'Connor Multi Manager team in 1998.

Markus Benzler heads the Multi-Managers, Private Equity, a business which forms a part of Real Estate & Private Markets (REPM) within UBS Asset Management. His role includes investment selection and portfolio management of several diversified international private equity mandates as well as UBS's Private Equity fund-of-fund businesses. Markus is a voting member of the Multi-Managers Private Equity and Infrastructure Investment Committees.

Anne Anderson is the Head of Fixed Income Australia and has overall responsibility for the Australian Fixed Income business and investment activities at UBS Asset Management. Anne is a member of the Global Fixed Income Investment Forum and chairs the macro forum that synthesises key macro and strategic themes that frame global fixed income strategies. Anne also chairs the Global FX and rates sub-committee. She joined UBS in 1993 and has held senior investment and managerial roles across the global and APAC regional businesses most recently establishing and building the Asian and China investment capability.

Philip Brides was appointed Co-Head of the Portfolio Management team within Investment Solutions, in January 2017. He is jointly responsible for oversight of all multi-asset and solution mandates, with the team, managing over CHF 100 billion in assets. In 2014, Philip joined UBS Asset Management from BlackRock, where he had been responsible for managing Global Tactical Asset Allocation (GTAA) mandates for retail and institutional investors. Prior to that, he was co-head of BlackRock's Dynamic Diversified Growth strategy. Philip is a member of the CFA Institute. He also holds the Investment Management Certificate (IMC) and the Chartered Alternative Investment Analyst (CAIA).

Erin Browne is a Managing Director & Portfolio Manager, O'Connor, based in New York. Erin manages an investment portfolio across multiple asset classes and geography, with a specific focus on currencies and equities. She joined the firm in 2016 from Point 72 Asset Management, where she worked as a global macro portfolio manager for the firm's Global Macroeconomic Group. Prior to that, Erin ran the global macro proprietary trading group at Citigroup. She has also held roles at Moore Capital Management and Neuberger Berman, having started her career at Lehman Brothers in 2002.

Tom Digenan is the head of US Intrinsic Value Equity team, responsible for US equities portfolio construction and research. Prior to this role, Tom had been a Strategist with the team since 2001, participating in the analysis and development of US equities portfolios, with a focus on alpha generation and ensuring client investment objectives were met. Tom is a member of the CFA Institute and the American Institute of Certified Public Accountants, and is on the board of CFA Society Chicago. He is currently Secretary/Treasurer of the CFA Society Chicago.

Jonathan Davies is the ad interim Head of Asset Allocation within the Investment Solutions team, based in London. The Asset Allocation team is focused on producing top-down views, strategic and active asset allocations and capital market assumptions. Jonathan also manages the firm's standalone currency strategies and the UK Balanced portfolios. He is a member of the Investment Solutions Investment Committee. Jonathan joined UBS Investment Bank in 1992 as a bond analyst in London, specializing in European bond markets.

Paul Guest is the Lead Real Estate Strategist for Real Estate Research & Strategy, a business which forms part of Real Estate & Private Markets within UBS Asset Management (UBS-AM). Paul joined UBS-AM's Real Estate business in November 2015. In this role, Paul is primarily responsible for supporting multi-regional investment mandates with qualitative and quantitative analysis of cross-regional economies and investment markets. He also liaises between business functions within UBS's Wealth Management and Investment Bank businesses. Paul is a member of the Fund of Funds and Multi-Manager Investment Committee.

Michael Ho joined UBS Asset Management as Chief Investment Officer, Investment Solutions in March 2017 where he has oversight of the Asset Allocation, Custom Building Blocks and Investment Solutions Portfolio Management teams. He was previously Chief Investment Officer for Alternatives at State Street Global Advisors (SSgA) responsible for building out the firm's liquid alternative capabilities and expanding its alternative offerings. Prior to this, he led SSgA's Global Macro and Active Emerging Markets teams. From 2008 to 2011 Michael was Chief Investment Officer for Mellon Capital Management, overseeing a team of over 130 investment professionals responsible for managing over USD 220 billion of assets.

Nathan Shetty was appointed Co-head of Portfolio Management, Investment Solutions team in January 2017. He is jointly responsible for the global oversight of all multi-asset and solution mandates, with the team, managing over CHF 100 billion in assets. Nathan was previously Americas Head, Investment Solutions, with a focus on client management and solution design as well as the lead Asset Allocation & Currency Strategist for the Americas within the Global Investment Solutions team. Prior to joining UBS, Nathan was a Managing Director at Mesirow Financial. He was the Head of the Investment Solutions Group and formerly a currency portfolio manager for their currency management group.

Kevin Russell is the Chief Investment Officer at O'Connor, based in New York. Kevin joined O'Connor from Citigroup where he spent his entire 22-year career, most recently as Global Head of Equities Trading, responsible for all risk and trading across equity, equity derivatives and equity financing products globally.

Geoffrey Wong is Head of Global Emerging Markets & Asia Pacific Equities, with overall responsibility for all Asian, Japanese and Australian equity teams, strategies and research. Geoffrey joined UBS in 1997. Prior to that, he was a co-founder of an Asian investment management firm, where he was responsible for asset allocation and stock selection for global and regional institutional portfolios. Geoffrey has also served on the board of the Singapore Stock Exchange.

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Who we are

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] Data as of 31 March 2017.
[2] Thereof around 1,200 from Corporate Center. Data as of 31 March 2017.

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