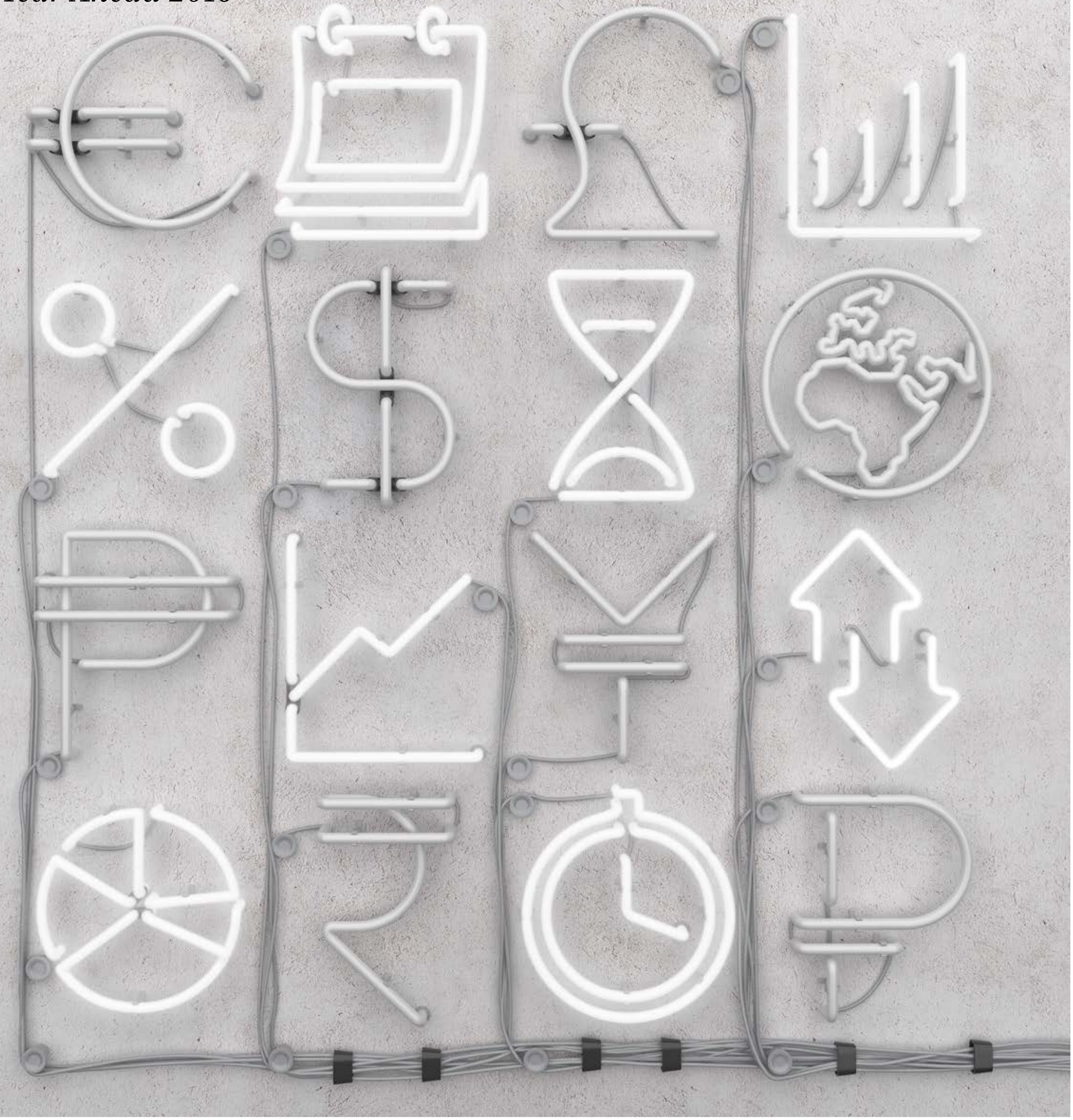
UBS House View

Year Ahead 2016



Chief Investment Office WM
December 2015

UBS

Dear Reader,

Welcome to our *UBS House View: Year Ahead 2016.*

In this, and in the accompanying *Years Ahead* publication, the global CIO team present our views on 2016 and beyond.

2015 was a year of big moves – from the removal of the Swiss franc floor, to the crisis in Greece, and equity market volatility in the third quarter. We face a world in transition – from drivers of growth in China and the emerging markets, to political structures in Europe, and the future of global monetary intervention. In such a world, we can expect more surprises. So, as we look to the year ahead, we seek to be as creative and thoughtful as possible in our analysis of the future.

This year we also present our most comprehensive digital offering ever: ubs.com/houseview hosts all of our *Year Ahead 2016* related content available across platforms, including mobile and tablet. We are also introducing a "My House View" feature, allowing you to compare your portfolio to the UBS House View, and to find the most personally relevant parts of our comprehensive investment content.

We hope you find our new digital experience useful and engaging, and that this *UBS House View: Year Ahead 2016* helps guide you, and your portfolio, successfully through our "world in transition."

Robert J. McCann
President Americas
and President Wealth
Management Americas

Mark Haefele
Global Chief Investment
Officer, UBS Wealth
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Mike Ryan
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Strategist, Wealth
Management Americas

World in transition

Mark Haefele
Global Chief Investment Officer

2015 was a year in which major developed equity markets finally rose 20%, then plunged 20%, and then finally rallied back again. How did you navigate the big waves? In such a market, even some of the world's most respected fund managers tumbled into double-digit negative performance.

Almost every month brought "surprises." Many things outside of our 2015 base case came to pass:

- The oil market has still not cleared.
- The Fed appeared to add global growth concerns as a reason not to move interest rates.
- Greece got close to leaving the Eurozone.
- China abruptly moved toward allowing the yuan to float freely.
- Volatility spiked to its highest levels since 2008.
- The Swiss National Bank abandoned its 1.20 currency floor against the euro.
- Far more Eurozone government bonds traded with yields in negative territory.
- The second quarter saw a rapid bond market sell-off.
- The Chinese equity bubble just kept inflating – until it didn't anymore.
- Many thought Chinese growth was falling uncontrollably.
- Emerging market currencies had a deep sell-off.

Getting the big things right
Surprises cannot be avoided – and that is the art and science of building a robust portfolio. First and foremost, a robust portfolio focuses on getting the bigger things right: strategic asset allocation and risk management.

In part, this means: *Accepting the unexpected.* At the start of 2015, the Swiss National Bank's decision to remove its currency cap against the euro came against our forecasts: we held an underweight position in the Swiss franc. However, our principle to limit the scale of tactical positions reduced the portfolio impact. Furthermore, our strategic decision to hedge portfolios against currency risk limited volatility for Swiss investors.

Staying true to your investment principles. Through August, the relatively muted performance of high quality bonds proved frustrating against the backdrop of plunging equity markets. While we hold an underweight in government bonds, they still have a role in diversifying our strategic portfolios. This principle of diversifying again began helping performance by September.

Working your process. With the sharp drop in equities through August and September, we reexamined our assumptions on the state of global growth, and concluded that "staying the course" through the volatility made sense. Working through an investment process fights the behavioral biases that often destroy performance.

A world in transition
For me, some of the most interesting things about 2016 are the transitions. The US faces a transition away from an era of zero interest rates/zero inflation, and we will learn the identity of President Barack Obama's successor.

With the constitutionality of European quantitative easing settled, Europe continues to transition as a political and economic bloc, which brings new challenges at every turn.

China is transitioning both from a manufacturing-led to a consumer-led economy, and from a state-directed to a free market. Both shifts will create uncertainty over China's growth path and the outlook for capital flows.

Other emerging markets will need to find new growth drivers, and will likely be pressured by US interest rate hikes.

Investment view
We enter the year positioned with an investment view based on several predictions:

- A modest acceleration in global growth will happen in 2016.
- 2015 did not mark the peak of the cycle for risky assets.
- China can both slow quickly and avoid a hard landing.
- We might be close to the bottom of the emerging markets and commodity downturn.
- Inflation will return, but not with destructive force.
- The political elections will cause lots of drama but less tragedy in 2016.

Our key tactical positions for the year ahead include an overweight position in equities relative to government bonds, a regional preference for Eurozone and Japanese equities, and US investment grade credit.

I wish you a healthy, successful, and interesting year ahead.

2015

Rights and wrongs

Right

- **US dollar vs. euro:** The European Central Bank extended its easing program, sending the EUR to a decade low.
- **British pound vs. Australian dollar:** The GBP continued its appreciation in 2015, while the AUD suffered from weak Chinese commodity demand.
- **Underweight EM equities:** EM equities underperformed in 2015, largely due to a decline in commodity prices and broad-based slowing in EM growth.

Wrong

- **Overweight Swiss equities** suffered after the sudden strengthening of the Swiss franc affected the outlook for exporters.
- **Underweight Swiss franc** was caught on the wrong side of the Swiss National Bank's decision to stop intervening to weaken the franc.
- **Overweight US high yield credit** fell short of expectations amid concern about the financial health of US-based oil drillers.

2016

Ups or downs?

Up
Equities
Global growth
Inflation
US interest rates
Oil

Down
Government bonds
Euro interest rates

Mixed
The US dollar
The euro

Same again
Volatility

The year ahead for US investors

Mike Ryan
Chief Investment Strategist
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Year Ahead – US Investors
The recent years have rewarded US investors who stuck to familiar asset classes. In both 2013 and 2014, a standard 60/40 mix of US stocks and bonds handily beat a portfolio that included "diversifying" assets, like international stocks, credit, commodities, or alternatives. Coming into 2015, we expected that to change, and in some respects it did. However, when the lights go out on December 31, we will likely look back on this year as one in which the strengthening dollar swept away many of the potential gains an investor could have had by broadening a portfolio into international assets.

What we learned from 2015
Our theme for 2015 was "The Diverging World," which ended up being particularly apt in foreign exchange markets. The US economy's outperformance leaves us in a more advanced stage than our peers, and as a result we find ourselves on the cusp of monetary tightening when most other countries are still mired in discussions about further easing. This has had a marked effect on global exchange rates, mainly as it concerns the US dollar's value, which rose broadly and sharply during the year.

The dollar's strength has eroded returns on unhedged international investments. To take an extreme example, Brazil's equity market was down nearly 8% in local terms for the year as of this writing, but over 34% in US dollar terms due to the collapsing real. In a similar vein, stellar returns in Europe (Italy +18%, France +15%) were spoiled by the euro's 11% fall, diminishing the benefit US investors could receive from diversifying away from US dollar assets.

Also reinforced for us in 2015 is that the downside risks we may have viewed as relegated to the commodities portion of the portfolio can unexpectedly leak into other areas like credit. For the second straight year, US high yield credit underperformed both US equities and US government bonds. A continued fall in oil prices, with only tenuous signs of stabilization, made investors who owned speculative grade bonds nervous about a possible rise in defaults, and spreads widened accordingly.

In truth, investment returns were lackluster across the board this year, with no single asset class in our strategic allocations returning more than 3% through 10 November. Overall portfolio returns would have been improved by including FX-hedged international equities (specifically, the Eurozone and Japan), but not enough to bring them into line with our longer-term estimates. Sometimes, stingy markets fail to provide a magic formula for beating a benchmark, and the only thing we can do is to look ahead.

What to expect in 2016

Thankfully, large swings in foreign exchange rates or commodity prices have diminished impacts as time rolls forward. The cross-currents of plummeting oil and a rising dollar wreaked havoc on economists' abilities to forecast growth and on investors' abilities to seize asset allocation opportunities. But they should not be as strong in 2016 as they were in 2015. For example, barring yet another 60% drop in the price of oil, energy company earnings will not experience the shock of an equivalent drop in their revenues next year. This is one reason we expect solid overall S&P 500 earnings growth of 8-9% in 2016 compared to less than 2% in 2015.

While we still look for risk assets to outperform in 2016, investors will need to continue to both dampen their return expectations and raise their tolerance for volatility.

Similarly, we do not expect the US dollar to continue its rise, at least not by enough to offset the better return opportunities overseas companies continue to provide US investors. The dollar has run significantly past its equilibrium value against the euro, yen, and many EM currencies. And while it's likely too soon to expect the dollar to relinquish its strong position, we do not see it making further gains during the year.

How to position portfolios

While we still look for risk assets to outperform in 2016, investors will need to continue to both dampen their return expectations and raise their tolerance for volatility. With equity markets already trading at, or somewhat above, historical fair value ranges, the prospects for a further material rerating of stocks are limited. This suggests that much of the returns to shareholders for this year will come in the form of earnings growth. The good news here, as we pointed out above, is that the effects from both a stronger dollar and weaker energy prices are poised to fade in 2016. So with the underlying trend of non-energy profitability still solid, overall earnings growth should revert to a mid to high single-digit pace.

Investors will need to remain selective however, as neither earnings gains nor market returns are apt to be uniformly distributed. As we begin the year, we will continue to focus upon those sectors within domestic equity markets that are leveraged to the ongoing US economic expansion, that generally have favorable earnings momentum, and/or trade at compelling attractive valuations. This includes technology and energy, as well as selective subsectors within healthcare (equipment and devices) and industrials (transports).

Although the valuations of small-caps are largely in line with long-term averages, we also still favor them over large- and mid-caps within the US. It is our view that small-cap earnings growth will continue to outpace that of larger-cap companies due to their higher exposure to domestic cyclical sectors. Small-caps also tend to perform well in the early stages of a Fed tightening cycle and when interest rates are on the rise. So with the Fed expected to continue its process of policy normalization and rates expected to trend higher, we see small-caps as well positioned for this stage of the business cycle.

Within non-US developed equity markets, we have expressed our preferred equity exposure with overweights to both the Eurozone and Japan. Eurozone equities should benefit from attractive valuations, strong earnings growth, and a supportive policy mix. Japanese stocks will also be bolstered by fiscal reform measures, as well as by a fundamental shift in corporate governance guidelines in favor of shareholders.

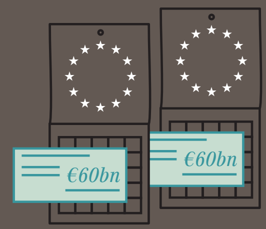
Lastly, we retain our preference for investment grade US corporate bonds. While we are likely past the midpoint of the US credit cycle, IG bonds feature wider spreads than they have for several years and therefore already reflect this risk. Because of its long duration and exposure to higher-quality companies, the asset class remains an important portfolio diversifier during periods of increased volatility and sell-offs in risk assets.

2015

January

The Swiss National Bank abandoned its policy of capping the value of the Swiss franc against the euro.

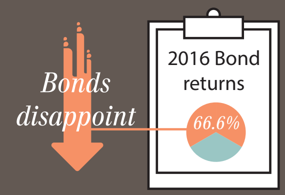
The European Central Bank announced a EUR 60bn per month quantitative easing program – the euro plunged to the lowest level in more than a decade.

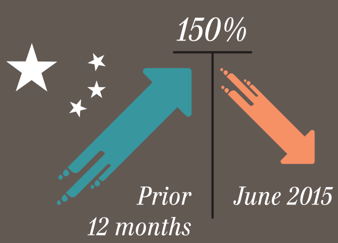


April

Bond markets sold off sharply on the prospect of higher US rates and signs of stronger Eurozone growth.

Our survey is not optimistic for 2016, with two-thirds expecting bond returns to disappoint.





June

After a close to 150% return in the prior 12 months, the Chinese equity market peaked. It is since down by a third.

July

"Grexit" entered everyday parlance.

August

China allowed the yuan to depreciate by 3%, provoking concern of a currency war.

3Q

Global equities suffered their biggest quarterly decline since 2011. The Fed kept interest rates unchanged in response.

September/October

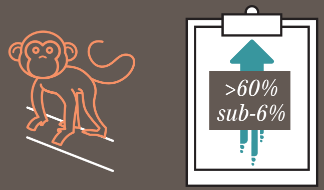
A migrant crisis tested European unity.

November

A series of terrorist attacks raised questions over global security.

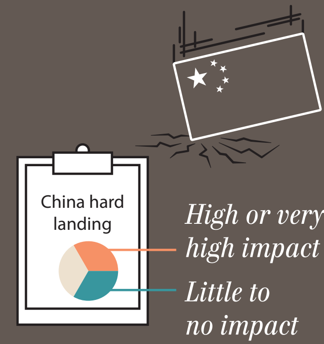
2016

February



Chinese Year of the Monkey. The optimism said to characterize people born in this year was not shared by our survey participants: more than 60% expect sub-6% growth.

One-third of our Industry Leaders Network* say a China hard landing would have a high or very high impact, one-third would expect little to no impact.

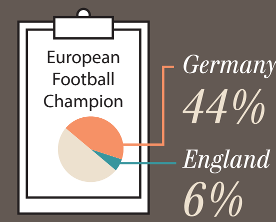


March

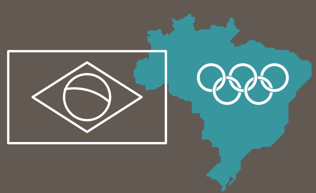
After four years of decline, our survey participants expect a rebirth for commodities: the asset class most widely expected to surprise positively in 2016.

June

Attention turns to France for the European Football Championship. 44% expect Germany to win. 6% expect England.

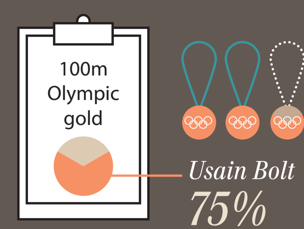


July

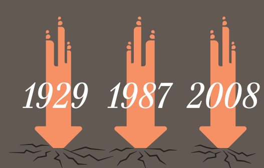


We are expecting recession for Brazil in 2016, but the year will probably be remembered for the country's first Olympic Games.

75% of our survey participants are backing Usain Bolt to win a third consecutive 100m Olympic gold.

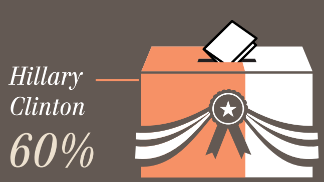


October

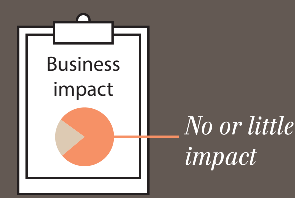


A feared month for equity markets, which crashed in the Octobers of 1929, 1987, and 2008. Almost two-thirds think the greatest 2016 risk is in emerging markets.

November

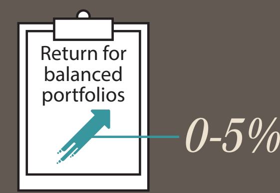


More than 60% of those surveyed expect Hillary Clinton to become the next US president. Either way, 79% of our Industry Leaders Network think the result of the US presidential election will have no or little to no impact on their business in 2016.



December

The majority of our clients are expecting a 0-5% return for balanced portfolios in 2016, according to the survey.



We surveyed 828 UBS employees and asked them what they think their clients would predict for the Year Ahead. *Our Industry Leaders Network is a proprietary network of UBS clients who are entrepreneurs or leaders in cyclical industries.

Six questions for 2016

To invest successfully in our world in transition, it is important to ask the right questions. Here, we try and identify "6 for 2016": six of the key questions, the answers to which could define the outcome for financial markets next year.

Kiran Ganesh, Editor-in-Chief
Christopher Swann, Cross-Asset Strategist

1

Did 2015 mark the peak of the cycle for risky assets?

As we enter 2016, global equities and high yield credit remain below their peaks reached in 2015. Are we merely partway through a correction, or did this year mark the year of transition from bull to bear?

In short: No. We are overweighting equities as we head into 2016.

No bull market can last forever, and fears mounted through 2015 that the post-crisis upswing in risk assets is finally running out of steam. The sheer duration of the rally has stimulated suspicion that we could be "overdue" for a decline: the US equity surge is now in its seventh year, making it the longest bull run since World War II uninterrupted by a more than 20% fall. Confidence was shaken in August and September by worries over China's growth, despite the fact that, at least according to official data, growth is meeting expectations.

Rallies in risk assets do not typically end for no reason. And today, none of the traditional catalysts for a bear market seem present:

Economic recession? No. Global growth disappointed expectations set by the IMF in 2015. But the miss was marginal (3.1% growth vs. 3.5% originally expected). We expect a modest reacceleration in 2016 to 3.4% from 3.1%, driven by stabilization in emerging markets (even if China goes on slowing), and modest increases in consumer spending in major developed economies.

Corporate profit recession? No. US earnings were temporarily depressed in 2015 by a strong dollar and the hit to energy companies from low oil and gas prices. These drags are likely to abate in 2016 (we actually see a slightly weaker dollar and higher oil prices through the year), and consumer spending remains robust. We expect 6–10% earnings growth. Elsewhere, improving growth in the Eurozone and Japan, accompanied by ultra-loose monetary policy, will support profits, and more stable economic growth and commodity prices should limit the pain on emerging markets.

Aggressive central bank hikes? No. The Federal Reserve and Bank of England are both likely to raise rates, but only gradually. Both have proved in 2015 that they remain responsive to economic conditions, and although inflation is likely to rise in 2016, central banks are unlikely to respond aggressively, given still-high structural deflationary forces.

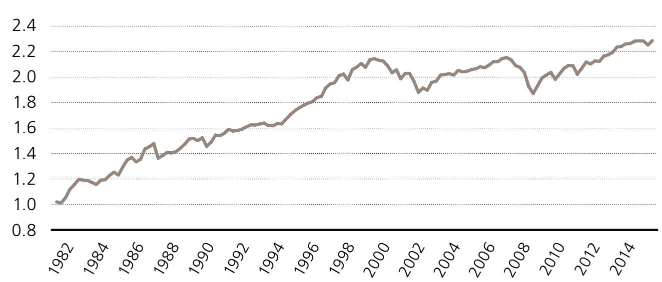
Bubble valuations? No. The MSCI All Country World Index is trading on a trailing price-to-earnings valuation of 18.4, relative to a long-run average of 16.9. Expensive? A little, but far short of the valuations usually associated with a valuation-driven sell-off. The index valuation peaked at 30.6 in 2000. We will continue monitoring the incoming data closely. Recessions are difficult to forecast, and corporate profits could be vulnerable to falling profit margins, in particular in the US, if wage growth starts to pick up. Similarly, a sharp rise in commodity prices could suffice to force central banks' hands. But these seem more like tail risks than forecasts on which to base investment decisions.

Investment conclusion: We are overweight equities as we head into 2016, with a focus on the Eurozone and Japanese markets.

Fig. 1

More to go for, even after a long run

S&P 500, logarithmic, rebased



Source: Bloomberg, UBS, as of November 13, 2015

2

Where do we stand on monetary policy?

Monetary policy seems set to diverge. The Fed is expected to tighten, while the ECB and Bank of Japan are on course to ease policy further. Where do we stand in the monetary policy cycle?

In short: It depends. But in general, central banks are likely to err on the loose side in 2016.

Last year's *Year Ahead* publication was entitled *The Diverging World*, in part due to our expectation that 2015 would see monetary policies diverge: between higher rates in the UK and the US on the one hand, and quantitative easing in the Eurozone and Japan.

But central bank policymaking has seemed far from predictable in 2015. So, how can we more effectively read the central banks' stances as we head into 2016?

We need to remember that:

- Central banks care about avoiding deflation. Since the financial crisis, the world has faced four significant deflationary forces: bank deleveraging, China's industrial oversupply, the use of new oil extraction techniques, and new technologies which have improved price transparency. Generating inflation against such forces is not easy, and in a world of high levels of nominal debt, central banks will look to ensure that a deflationary spiral does not ensue, and will fight this with determination if it appears close.
- Central banks are not compelled to act while wage inflation is low. Although economic data is decent and unemployment is low in both the US and the UK, and we expect the Fed and BoE to hike interest rates in December 2015 and May 2016, respectively, we note that neither central bank is strongly compelled to act while wage inflation is so low. Without higher wages, their mandates of meeting inflation targets over the medium term and maximizing employment can be fulfilled without changing rates.
- Central banks don't have to follow market expectations. It might be comforting to believe that the central banks can be "forced" to act by the markets, but 2015 proved that there is no particular desire among the current cohort of central bank chiefs to dance to the markets' tune. The Fed surprised the market by leaving rates on hold in September, the ECB did not announce any new action to prop up a declining bond market in April and May, and the Bank of Japan has not added to its easing program, despite the Japanese economy disappointing expectations.

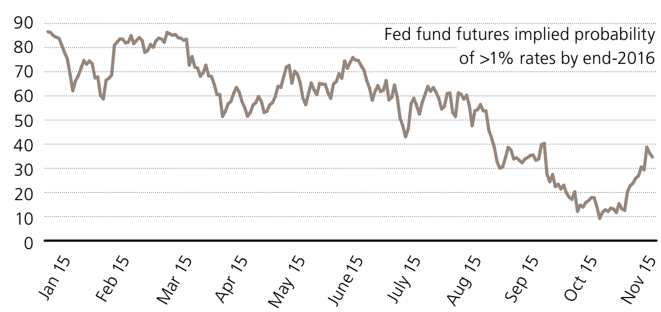
Our base case is for the Fed to increase interest rates to 1.25–1.50% by end-2016, for the ECB to prolong quantitative easing beyond the scheduled end-date of September 2016, and for the BoE to commence hiking in May 2016.

That said, all of the lessons of 2015 suggest we should exercise caution in these forecasts.

Investment conclusion: We should prepare for another year of potential central bank surprises, and with deflationary forces still persistent and little sign of significant wage inflation, we should also expect policy to err on the side of "loose" in case of doubt.

Fig. 2

Will they, won't they? The market is uncertain about central bank action



Source: Bloomberg, UBS, as of November 13, 2015

3

Can China control its slowdown?

A disorderly crisis in China is not our base case, but ranks as one of the most serious potential tail risks to financial markets in 2016. In the first year of its 13th Five-Year Plan, can China control its slowdown?

In short: Yes and no. It cannot stop a slowdown, but should avoid major disruption.

Make no mistake. China has a lot of problems:

- Leverage is too high and growth is over-reliant on credit. Total credit-to-GDP has risen to around 250% by 2015 from about 150% in 2008, and we now estimate that around 14% of total GDP is spent on interest payments to creditors. With nominal growth slowing, debt service is becoming an increasing challenge for Chinese companies, who are already among the most overleveraged in the world on a corporate debt-to-GDP basis.
- Property is in vast oversupply. During a real estate boom between 2010 and 2012, construction outpaced demand for new properties – leaving a large inventory of unsold homes. If home sales remain strong, this glut will recede over the coming year and construction spending will recover. If not, house prices will resume their slide, consumer confidence will suffer and construction firms will run into financial trouble. China's financial sector is also heavily exposed to the housing sector and property development.
- China has a legacy of industrial overcapacity thanks to prior short-term, growth-boosting stimulus efforts. This leads to three key problems: 1) large swaths of the manufacturing base are unprofitable and need increasing sums of government money to keep them operational; 2) China's employment base is too heavily linked to these unprofitable industries, and needs retraining; 3) overcapacity in old industries is crowding out newer, potentially more efficient solutions.

From here, China clearly needs to find new drivers of growth. Yanking the old levers of increased property and industrial development will only lead to ever-greater debts. But these old industries need help adjusting: China cannot afford mass unemployment and/or a banking sector crisis.

Ominous as it sounds, we do believe the Chinese government stands a good chance of managing this process. We expect growth to slow to 6.2% in 2016 from 6.9% this year. But notably, despite the concerns mentioned above (which we also had a year ago), growth in 2015 actually exceeded our expectations.

Chinese authorities have the advantage of a state-controlled banking system. A market economy investment boom is typically followed by a wave of bankruptcies, with knock-on effects on consumer confidence, business sentiment, and wider lending standards. China can support failing firms by doling out cheap loans, thereby staggering corporate failures and averting disruption.

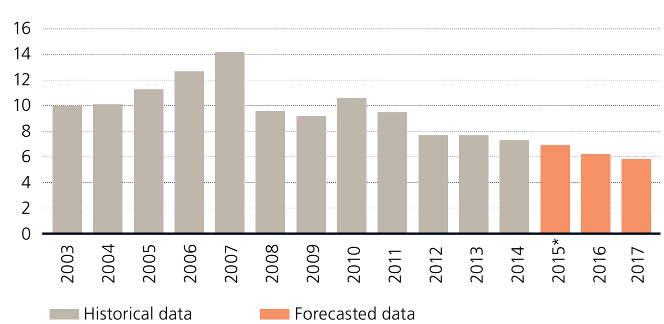
The Chinese government also has the resources to backstop the financial system – with USD 3.5 trn in currency reserves and a debt-to-GDP ratio of just 40%. That reduces the threat of a Lehman-style contagion event.

Investment conclusion: In short, we expect China to slow, but not to disrupt the wider picture for risky assets. We are overweighting equities in 2016, and have recently upgraded emerging market equities to neutral, and Chinese equities to overweight, in the context of emerging markets.

Fig. 3

Slower, but that's all

China GDP growth and forecast (%, yoy)



*2015 represents YTD plus forecast
Source: UBS, as of November 13, 2015

4

Are we close to the bottom in the EM/commodity downturn?

With consistently underperforming developed markets – and Brazil and Russia in deep recessions – gloom at times pervaded EM in 2015. Commodities have plumbed multi-year lows. Is this the dark before the dawn?

In short: Yes. But the emerging markets hype is unlikely to return.

EM have lost much of their shine since 2010. Equities there have lagged developed markets by almost 60% over that period, and GDP growth has more than halved since. A combination of waning investor enthusiasm and cash outflows by residents means that EM are set for their first net capital outflow in 27 years in 2015, according to the Institute for International Finance.

With China slowing, commodity prices tumbling, and political and economic crises in Russia and Brazil, EM equity valuations have been left close to their lowest level since 2008, and the extreme currency weakness through 2015 has significantly improved external competitiveness.

Whether 2016 truly marks a turning point will depend on several factors:

- **China avoiding a hard landing:** If China's government engineers a gradual slowdown, EM confidence overall will benefit. China accounts for 24% of the MSCI EM Index. It is also the top export destination for Brazil and Malaysia, and the second-largest customer for Russian companies.

- **A return to profit growth:** EM corporate profits have contracted by 26% since 2011 in US dollar terms and 2% in local currency terms. In the tough market conditions of recent years, many firms have focused on preserving market share, rather than maintaining earnings or profit margins. A pickup in earnings and margins would provide solid evidence that the worst is over for EM investors.

- **Moderate tightening by the Federal Reserve:** A rapid accumulation of debt has made EM firms more vulnerable to rises in US interest rates. The International Monetary Fund calculates this load has now risen to USD 18 trn, four times its level in 2004.

- **A steadying of commodity prices:** While top EM, including net importers like China and India, benefit from lower commodity prices, many developing countries are highly reliant on raw materials exports. The likes of Brazil, Russia, Indonesia, and South Africa have been harmed by tumbling commodity prices.

All of the above are consistent with our base case. We expect a slowdown, but not a hard landing, in China. We expect 2–6% profit growth for EM companies. The Fed is likely to remain cautious, and we believe commodity prices will move higher, overall, through 2016. This suggests that the worst is probably over.

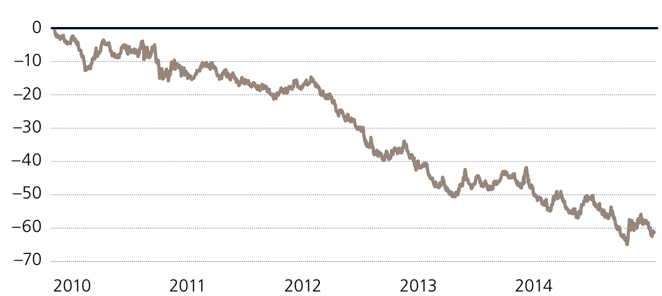
Challenges still remain though, not least the need to find new drivers of growth and deleverage the private sector. So while the worst for EM has probably passed, we do not expect the exuberance of the mid-2000s hype over the BRICs – Brazil, Russia, India and China – to return.

Investment conclusion: We recently upgraded our stance on EM equities from underweight to neutral, to reflect the more favorable outlook.

Fig. 4

The dark before the dawn?

MSCI EM vs. MSCI World performance (rebased)



Source: Bloomberg, UBS, as of November 13, 2015

5

Is 2016 the year inflation returns?

Bank deleveraging, commodity crashes, technological change, oversupply, secular stagnation… Pick your reason, but inflation has been absent since the financial crisis, despite central banks' efforts. Will inflation move higher next year?

In short: Probably. But it also probably doesn't matter.

The hyper-inflation that some economists feared from central banks' money printing after the 2008 financial crisis did not materialize. Instead, price rises have fallen persistently below official targets in recent years. Three-quarters of the 34 OECD nations had inflation of 1% or below in late 2015. Ten OECD nations were even experiencing falling prices as of August 2015. That compares to a 2% target set by most developed nations.

We think next year is likely to see inflation return toward more normal levels, especially as oil prices stop falling. Lower oil prices will exert progressively less drag on year-over-year headline rates of consumer price inflation starting next January. And while core inflation rates theoretically exclude energy, sharp moves in oil prices can still have an impact on almost all prices, given that they represent an input cost for a vast range of goods. As the energy effect wanes, inflation should increase.

Overall we expect inflation in 2016 to move up to 1.6% (from 0.2%) in the US, and to 1.0% (from 0.1%) in the Eurozone. A modest rise in inflation would be welcome, helping reduce the threat of deflation. But what will matter most to asset prices is central banks' reaction. In theory, central banks should react to higher headline inflation rates by tightening monetary policy. But in reality, most monetary policy setters tend to look through the effects of varying energy costs, as was the case when oil prices increased in 2011.

Rather than an energy-driven rise in inflation rates, what might be more troubling for markets would be an increase in prices driven by higher wage agreements. This is most likely to occur in the US or the UK, where unemployment rates are low enough to seem consistent with workers beginning to demand higher pay. Should this occur, central banks would take notice, and markets could have cause for concern about the outlook for corporate margins.

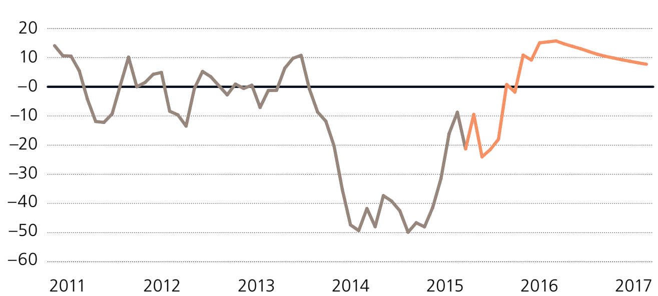
But with a relatively high share of underemployed or part-time workers available to rejoin the labor force, and with labor's bargaining power having diminished relative to capital in recent years, the prospect of a significant wage-price spiral still seems distant.

Investment conclusion: So, overall, while we believe that inflation will probably move higher in 2016, it will largely be driven by energy prices and so represents little cause for alarm.

Fig. 5

Energy prices will begin contributing to inflation

Change in oil price yoy, assuming forward pricing, in %



Source: Bloomberg, UBS, as of November 13, 2015

6

Will politics affect markets in 2016?

With the US presidential election, Brexit, a migrant crisis in the EU, and an economic crisis in EM all in play, politicians and electorates will play a crucial role in our world in transition. Will unpleasant political surprises in 2016 put economic growth at risk?

In short: Yes. But we do not expect a long-lasting impact on economies or markets.

Potential dramas will likely come from:

- **Mainstream politicians losing ground:** Anti-establishment candidates have been launching a strong challenge in both the Republican and Democratic primaries ahead of November's US elections. In Europe, more extreme parties have been on the rise in France, Italy and Spain. That could further slow the pace of reform. A similar peril is present in EM, where falling commodity prices have strained many political systems. Investors will also be alert for signs of a deepening political crisis in Brazil.

- **Anti-immigration sentiment causing more disruption:** A wave of refugees from the Middle East has been adding to the political angst in Europe. German Chancellor Angela Merkel's commitment to open borders has increased the threat that she will be displaced. At the end of 2015, Poland elected an anti-immigrant government, while the power of the political right has also been on the rise in Denmark, Switzerland, the Netherlands, and Belgium.

- **Questions about security:** The terrorist attacks in Paris and the further rise of the Islamic State could hurt consumer confidence and spending. The West's stance on Syria is also now more complex.

- **Britain moving toward an EU exit:** The anti-immigrant spirit also appears to have undermined support for British membership in the European Union, which will be put to a referendum either in 2016 or 2017. Mounting support for a "Brexit" could take a heavy toll on financial markets – undermining confidence in both the UK and the Eurozone. Without Britain, the EU would be more likely to drift away from market-friendly policies.

- **Concerns about the end of Abenomics:** Reforming Prime Minister Shinzo Abe could have his wings clipped by legislative elections, expected around July 2016. Winning a majority in the Upper House is critical to ensuring that the structural reforms he has promised can be delivered. With the Abe administration's approval rating falling below 40% after unpopular national security bills, victory is not assured.

These trends are undoubtedly worrying and will most likely cause market noise in 2016, but we do not expect to see any major upsets.

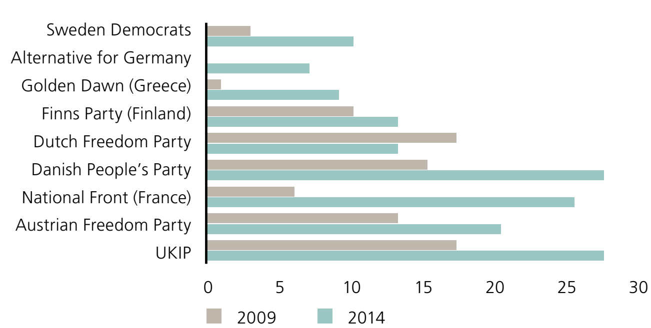
Consumers have historically shown remarkable resilience against terror threats. The US primary campaigns often throw a spotlight on the most extreme wings of each party, but they would be unlikely to prevail against a centrist in a general election. Meanwhile, the political establishment in Britain is lining up in favor of continued membership in the EU. And the pro-EU Prime Minister David Cameron has the advantage of being able to choose the timing of a vote. Finally, in emerging markets, while there are many political perils, Argentina's recent shift away from populism is an encouraging sign that economic hardship can also propel voters toward more pro-market policies.

Investment conclusion: In short, we do not expect politics to create a long-lasting market impact in 2016, and remain broadly confident in our pro-risk stance.

Fig. 6

The rise of fringe parties

European Parliamentary elections, share of vote, in %



Source: Wikipedia, as of November 13, 2015

Global economic outlook

Brian Rose, US Economist, Wealth Management Americas
Ricardo Garcia-Schildknecht, Head of Eurozone Economics
Philip Wyatt, Head of APAC Economics
Jorge Mariscal, Head of EM Investment Office
Daniel Kalt, Chief Economist Switzerland

We expect growth to pick up in 2016 after a dip in 2015. But our overall view of a world in transition trudging along at an okay but slow pace remains unaltered. We expect this to be the fourth year in the past five of precisely 3.4% growth.

Growth in unexpected places
In a year when concerns over a "Grexit" and a "China hard landing" topped financial headlines, we note that both China's and the Eurozone's economies grew faster than originally expected in 2015.

China slowed, but our forecast of +6.8% growth proved marginally pessimistic: we now think it will end the year at +6.9%. And Eurozone growth of +1.5% is likely to surpass our original projection of +1.2%.

The US disappointed expectations (+2.5% vs. +2.9% expected), primarily due to harsh weather in 1Q. Growth for the remainder of the year has met our positive expectations.

Elsewhere, Japan disappointed greatly (+0.5% vs. 1.2% expected), as the economy failed to gain steam after last year's consumption tax hike, and India surpassed expectations, though the country's new GDP calculation methodology makes comparison difficult.

The major shortfalls came in commodity-exporting emerging markets. Our forecast of close-to-zero growth in Russia and Brazil was instead met with deep recession in both countries; Russia is likely to contract by 3.7% and Brazil by 3.0%.

Expect accelerated growth for 2016
We expect global growth to accelerate next year to 3.4%, from 3.1% this year.

The growth "impulse" for 2016 is likely to be more evenly distributed than in 2015, when developed markets took much of the burden of accelerating growth.

We expect around half of the rise in global growth next year to be distributed across developed markets, with the other half from emerging markets, in particular due to the ongoing pickup in Indian output and stabilization in Brazil and Russia.

China's slowdown will represent the single biggest drag on global growth relative to the previous year.

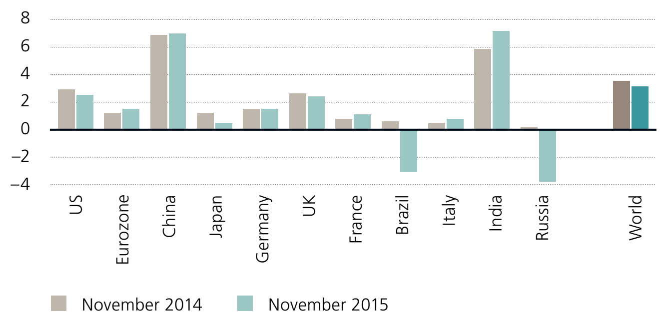
Key risks to global growth
We see the following as the key risks to our forecast of a global growth acceleration for 2016:

- US consumption and investment suffering as a result of higher interest rates.
- A renewed political crisis in the Eurozone affecting consumer confidence.
- Japan's economy continuing to fail to respond to stimulus measures.
- China's manufacturing sector slowing more rapidly, and damaging consumption, leading to a faster-than-expected slowdown in overall growth.
- Commodity prices continuing to slide, affecting exporting nations, with importing consumers not spending their savings.
- A financial crisis in the emerging markets resulting from escalating capital outflows.
- A geopolitical event which affects confidence, potentially involving Russia and the Middle East.

Fig. 7

2015 growth expectations – and how they played out

UBS 2015 real GDP growth forecast, in %

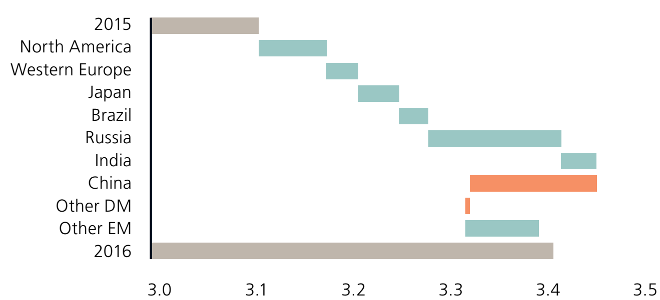


Source: UBS, as of November 13, 2015

Fig. 8

Drivers of growth are evenly spread

Contributors to acceleration in global growth, in %



Source: UBS, as of November 13, 2015

Regions

US demand improving
We expect US growth to accelerate in 2016, to 2.8% from 2.5%.

Consumer demand will be supported by an improving labor market, a pickup in lending growth, positive wealth effects, and rising household formation.

We expect business investment to rise at a modest pace, though companies are still generally cautious. Uncertainty due to the presidential election in November could affect investment spending in the latter part of the year, but we do not expect major post-election changes to materialize until 2017.

As in other regions, US inflation is likely to rise, thanks to more stable commodity prices. But the risk of higher core prices in the US is greater than in other regions, due to the relatively low level of unemployment and higher levels of growth than in other regions.

The Fed is likely to raise interest rates in response, but cautiously, we think, only if raising rates shows no detrimental impact on growth.

European recovery to continue
For the Eurozone, we expect growth to rise to 1.8% in 2016, from 1.5% in 2015. Growth in the UK should remain good, at 2.4%.

We believe monetary stimulus will continue to boost GDP momentum, and private consumption is set to remain strong, given exceptionally low borrowing costs and strong consumer confidence.

Capital expenditure should strengthen substantially as the recovery becomes more established. Business confidence is improving, and recent lending surveys suggest that bank lending is becoming more accessible.

Exports are unlikely to prove a major boon for the region, given that the bulk of euro weakness is now behind us, but fiscal policy is set to become a mild tailwind for growth. The EUR 315bn European Fund for Strategic Investment should provide some stimulus in the quarters ahead.

Ongoing slowdown in Asia
Overall, we expect Asia's growth to slow slightly in 2016, for the third consecutive year, stalled mainly by China's slowdown.

In the first half of 2016, we believe that high levels of inventory in China are likely to mean that new investment and industrial activity will be weak, with fixed asset investment decelerating further.

By year-end, as the property destocking process ends, we look for stable single-digit fixed asset investment growth. China should also receive support from government policies which promote new investment in health, utilities, and high-tech investment sectors.

However, a considerable drag will remain from maintaining large excess capacity in certain heavy industries, which will take years to reduce.

Weak underlying inflation means there is scope for monetary policy to be eased further.

UBS GDP growth and inflation forecasts

Country	Real GDP growth (%)		Consumer price inflation (%)	
	2015	**2016**	**2015**	**2016**
Australia	2.2	2.6	1.5	2.2
Brazil	–3.0	–2.0	9.9	6.4
Canada	1.1	2.2	1.5	1.9
China	6.9	6.2	1.5	1.5
Eurozone	1.5	1.8	0.1	1.0
France	1.1	1.5	0.1	1.2
Germany	1.5	1.9	0.2	1.0
Italy	0.8	1.5	0.2	1.4
Spain	3.2	2.7	–0.6	0.6
India	7.1	7.6	5.0	4.6
Indonesia	4.7	4.9	6.4	5.0
Japan	0.6	1.3	0.9	1.0
Mexico	2.3	2.7	2.6	3.5
Russia	–3.7	–0.4	15.6	6.9
Switzerland	1.0	1.4	–1.2	–0.4
UK	2.4	2.4	0.1	1.1
US	2.5	2.8	0.2	1.6
World	3.1	3.4	3.5	3.8

Source: UBS, as of November 24, 2015

Subdued growth in emerging markets
Growth in EM will remain subdued, but should improve in aggregate. We expect 4.3% growth for developing economies, relative to 4.1% in 2015.

The plunge in many currencies this year has boosted competitiveness. From here, weaker currencies should improve current account positions and the potential for positive growth surprises.

However, private sector deleveraging will need to continue in several countries. Furthermore, the falls in many EM currencies mean that USD debts are now more burdensome. Some countries could see downgrades in credit ratings or outlooks in 2016.

EM policy makers will look for opportunities to ease fiscal and monetary policy, but the scope to do this will be more limited in those countries which have experienced the most severe currency depreciation.

Domestic strength in Switzerland
The Swiss economy has skirted a recession after the EURCHF shock at the beginning of 2015.

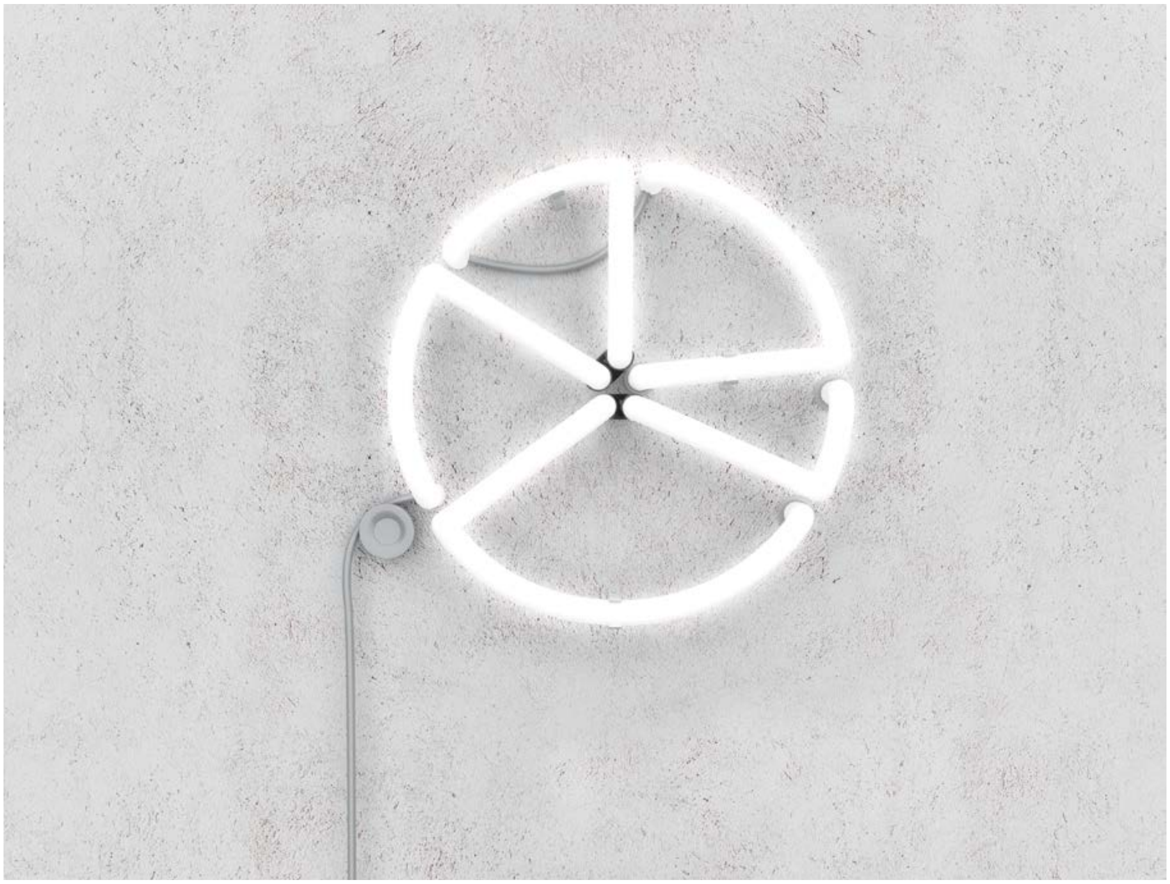
The booming domestic economy is acting as a buffer, absorbing the bumps and jolts in export sectors created by the strong Swiss franc. Yearly immigration of roughly 1% of the population, together with the Swiss National Bank's still super-loose monetary policy stance, will continue supporting consumption and construction spending. Net exports and investment spending will, however, weigh on real GDP growth, which we expect to come in at 1.4% in 2016. Consumer prices, already down 1.2% in 2015, will likely retreat further, but at a lower rate as the base effects from lower oil prices and a strong currency are expected to fade. There is no reason, though, for the SNB to tighten its policy stance anytime soon.

GDP in USD terms shrank massively in some countries since 2012
World economies by GDP (current USD)

Change vs. 2012	Rankings		2012–2016 change
unchanged	1	US	16%
unchanged	2	China	45%
unchanged	3	Japan	–30%
unchanged	4	Germany	–2%
up 1	5	UK	16%
down 1	6	France	–7%
up 3	7	India	30%
unchanged	8	Italy	–10%
down 2	9	Brazil	–31%
up 1	10	Canada	–13%
up 3	11	South Korea	19%
up 1	12	Spain	–7%
down 1	13	Australia	–19%
up 1	14	Mexico	0%
down 6	15	Russia	–42%
unchanged	16	Indonesia	–5%
unchanged	17	Netherlands	–6%
unchanged	18	Turkey	–9%
up 1	19	Switzerland	3%
down 1	20	Saudi Arabia	–12%

Source: IMF, UBS, as of November 13, 2015

Turning forecasts into investments



Mads Pedersen,
Head of Global Asset Allocation

Katarina Cohrs,
TAA and Investment Methodology

Whether investing for the long or the short term, we believe that a consistent approach helps deliver consistent performance. Here we summarize part of the investment philosophy that goes behind our tactical investment recommendations, from deciding to be "risk-on" or "risk-off" to selecting within specific asset classes.

Risk-on or risk-off?
Deciding whether or not to take on risky assets such as equities and high yield can make a sizable difference in returns.

Our decision-making process is based on two pillars:

First, the quantitative aspect. This incorporates developments in both the global business cycle, and "price momentum."

We generally believe that if both the trend and dynamics in global earnings and business activity are positive, we should be in a supportive environment for risky assets too. Fundamentally, equities represent a claim on future cash flows: if the trend of those cash flows is positive, the outlook for equities should be positive too.

Meanwhile, over short-term horizons, markets often experience a trend phenomenon, i.e. if markets have been moving up, they are more likely to continue going up than go down. This can, in part, be attributed to the behavioral effect of "conservatism," whereby people continue adhering to existing beliefs, rather than adjusting fluidly to new information. As such, improvements in the fundamental outlook can take time to filter into prices.

Second, we analyze the implications of qualitative factors. These include such events as changes in central bank or government policy stances. In our world in transition, interventionist policy is playing an active role in shaping financial market returns, sometimes for the positive and sometimes for the negative.

The market looks cheap. Time to buy?
Not necessarily. Over a long time horizon, valuation is an important basis for investment decisions, and the longer that horizon, the more important valuation proves. However, over shorter time frames, such as our six-month tactical investment time horizon, valuation does not prove to be a particularly useful indicator of subsequent returns.

Markets which are cheap can often get cheaper still, if sentiment or business cycle dynamics are working against them. Emerging markets have been a good example of this over recent years. Similarly, those markets which seem fully valued can maintain their value, or get even more costly, with the right support from the business cycle and sentiment. The US equity market in recent years is a case in point.

As such, while valuation is an important indicator for long-term strategic asset allocation decisions, it does not play a major role in our tactical investment decision-making.

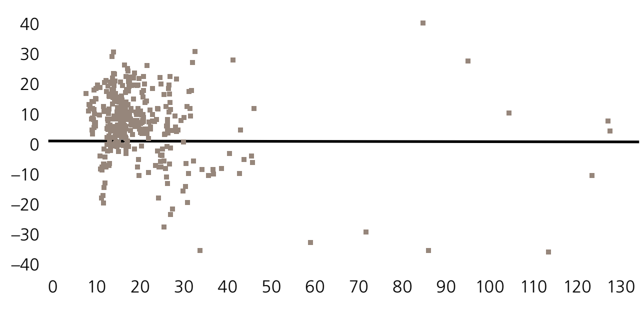
How to decide between equity regions?
By buying an equity index, an investor buys a stake in the future profits of a variety of businesses. As such, much of our regional decision-making framework looks at the likely change in profits in different regions. We incorporate recent moves in currencies, which could indicate a change in the outlook for exporters; dynamics in manufacturing sentiment, which could indicate a change in local economies; and both the growth and rate of change of corporate profitability itself. We also incorporate a "momentum" component, to account for changes in sentiment toward different markets.

We note that not all factors are of equal importance for each market. For instance, equity markets which are made

Fig. 9

Valuation not a major driver of short-term returns

Subsequent 6-month total return vs. trailing price-to-earnings ratio, S&P 500

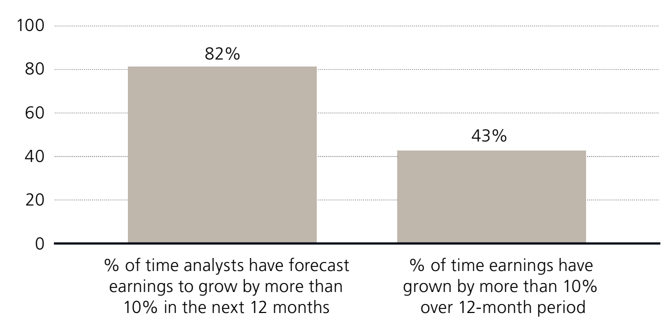


Source: Shiller, UBS, as of November 13, 2015

Fig. 10

Sometimes it's better to look at reality than forecasts

IBES earnings estimates for MSCI US, monthly data since 1988



Source: Thomson Reuters, UBS, as of November 13, 2015 up primarily of exporters, such as Switzerland, tend to be more heavily influenced by currency, and those which can be more trading-oriented, such as Japan, are more momentum-driven.

In addition, we consider extraordinary factors like changes in central bank policy, which have become increasingly important drivers of equity market returns in recent years.

How to know if yields are set to rise?
Perhaps the most persistent source of frustration for investment forecasters in recent years has been the steady decline in government bond yields. Despite decent economic growth, falling unemployment, and markets which have generally been pro-risk, government bond yields have trended lower.

This shows us that there are more than economic fundamentals at work in the bond market. Our framework acknowledges the mix of fundamental and technical factors which drive the market, and combines technical factors, including investor sentiment, alongside more fundamental ones, such as trends in the business cycle.

We cannot be sure precisely when yields are set to rise. But with a focus both on the technical factors and the fundamentals, we feel our framework should help us identify the forces at work in the market.

When is the time to take credit risk?
As with other asset classes, we attempt to answer this question through a quantitative and qualitative approach.

Our quantitative approach looks at both the possible future direction of spreads, and the compensation investors are currently receiving in exchange for default risk.

The spread models incorporate fundamental macroeconomic variables, indicators of global risk appetite, and country-specific indicators. Meanwhile, the default rate model incorporates fundamental factors for the first year, before assuming mean reversion through the business cycle.

On top of this, we assess qualitative factors, such as trends in new issuance (in which high levels of supply can actually be positive for asset classes like high yield, to the extent they indicate positive sentiment and easy refinancing conditions), changes and trends in credit ratings, and assessments of liquidity, which is particularly important for high yield credit.

How to decide on the best currencies today?
Most investors should hold the majority of their assets in their home currency. However, we also believe that, over a short-term horizon, currency markets may provide an opportunity to generate tactical performance.

Currencies are influenced by perhaps more factors than any other asset class. Ultimately, we believe that in the long run, currencies should revert toward their fundamental value. As such, our decision-making process includes estimating how over- or under-valued currencies are, relative to long-term purchasing power parity or interest rate parity trends.

However, we note that deviations can take a long time to correct. Therefore, to complement our tactical decision-making process, we also look at short-term factors. We monitor business cycle dynamics closely, since we believe that currencies generally should strengthen when growth and real interest rates are high, and weaken when growth and real interest rates are low. It is also important to consider overall market volatility and positioning. High interest rate currencies tend to be favored at times of low market volatility, and we need to consider the risk of such “carry trades” if positioning is stretched, or if volatility spikes.

When is the right time to buy commodities?
For investors who consider commodities as an asset class, we believe tactical decisions should be made based on four factors: first, developments in the global business cycle, given that increased economic activity tends to imply increased commodity demand; second, the performance of commodity-related equity markets, which has historically been shown to “lead” commodity markets, and can therefore serve as a useful indicator; third, “roll costs,” given that an upward or downward sloping curve can have an important bearing on total realized commodity returns; and finally, price momentum, given the tendency for commodity prices to move in long trends, or cycles, over time.

Global tactical positioning

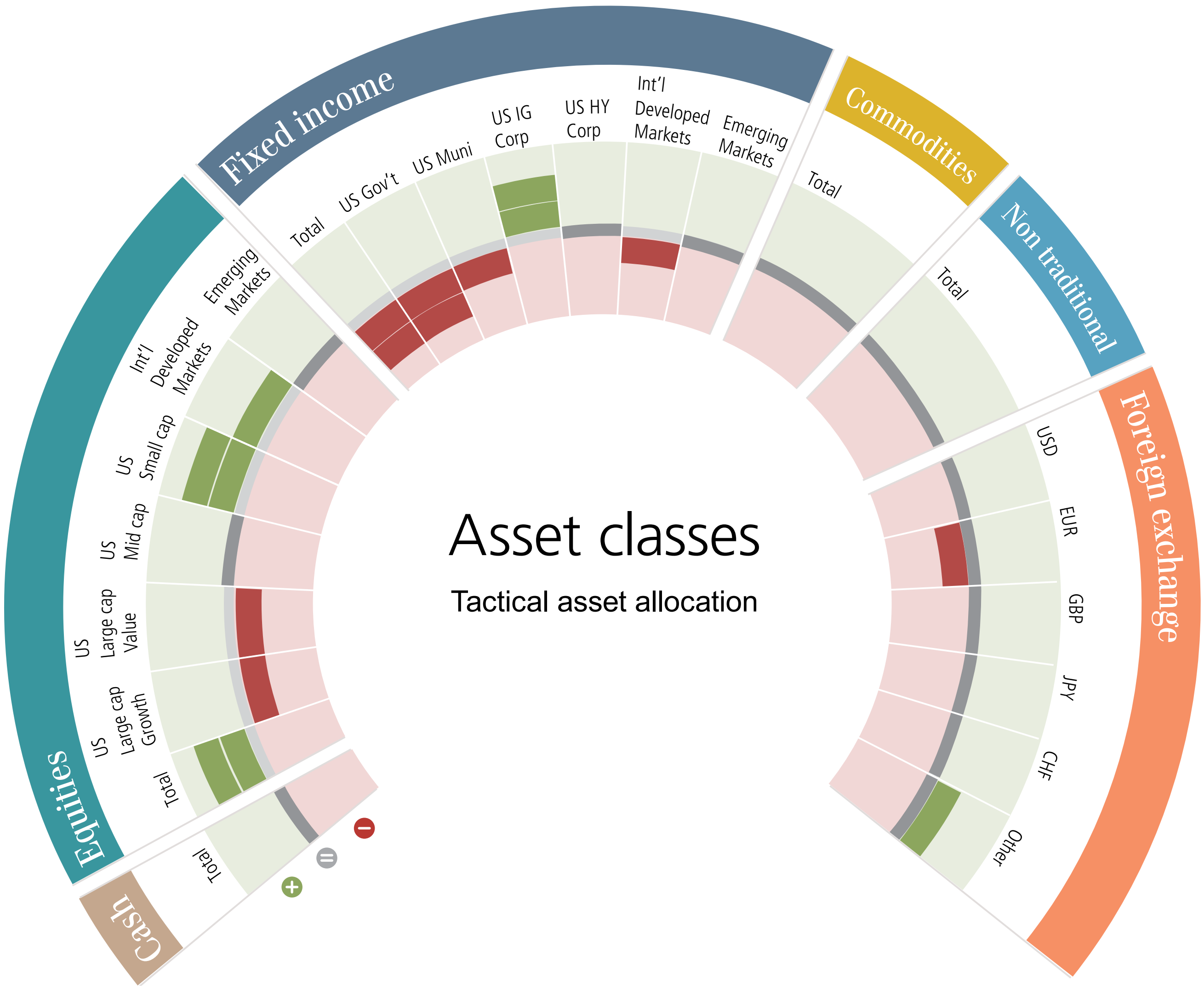
Brian Nick, CAIA
Head of Tactical Asset Allocation US

Mads Pedersen
Head of Global Asset Allocation

Mark Andersen
Head of Regional Asset Allocation

Our position for our world in transition is an overweight in equities relative to bonds. With the global economy recovering from this year's modest slowdown, corporate profitability on track, and interest rates likely generally low, our outlook for equities is positive. Our preferred regional markets are the Eurozone and Japan, while we are more cautious on UK equities. Within US equities, we prefer small- to large-cap companies.

Within bonds, we are overweight US investment grade credit, which provides an attractive yield pickup over government bonds and wider credit spreads to help cushion the impact of rising interest rates. We are underweight the safest government bonds.



Overweight: Tactical recommendation to hold more of the asset class than specified in the moderate risk strategic asset allocation

Underweight: Tactical recommendation to hold less of the asset class than specified in the moderate risk strategic asset allocation

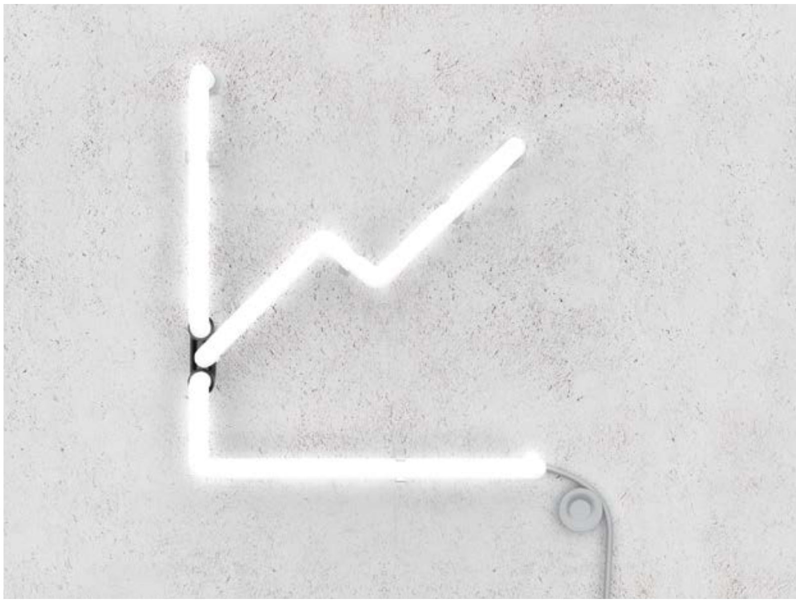
Neutral: Tactical recommendation to hold the asset class in line with its weight in the moderate risk strategic asset allocation

Each bar represents a +/- 2% tactical tilt or part thereof (i.e., one bar = 0.5% to 2%, 2 bars = 2.5% to 4%, 3 bars = over 4%). **NOTE: TACTICAL TIME HORIZON IS APPROXIMATELY SIX MONTHS**

As of November 20, 2015

See the latest *UBS House View: Investment Strategy Guide* for an interpretation of the tactical deviations and an explanation of the corresponding benchmark allocation.

Equities



Jeremy Zirin, CFA, Chief Equity Strategist, Wealth Management Americas
David Lefkowitz, CFA, US Equity Strategist, Wealth Management Americas
Markus Irngartinger, Head of Macro & Equities Strategy

We are positive on the outlook for equities next year. Our preferred regional markets are the Eurozone and Japan, which should benefit from rising earnings, low refinancing costs, and currencies which are weak on a trade-weighted basis.

Global

Positive stance on global equities justified in a difficult year
The first quarter of 2015 saw good performance from global equities, with the Eurozone leading the rally thanks to loose monetary policy. The markets stalled by 2Q, amid concerns about the potential impact on equities of higher yields following a sell-off in the bond market, though Japanese equities still performed well.

In 3Q, all global equity markets fell as concerns arose over the state of Chinese economic demand and the knock-on effect on commodity prices. Emerging market currencies and equity markets were most severely affected, and the materials and energy sectors fell sharply, dragging on developed market equity performance.

At the time of writing, 4Q has seen a sharp rally, with the worst-performing sectors in 3Q bouncing back.

Overall, we believe a positive stance on equities has been justified: presently, global equity returns are in positive territory for the year. But investors have needed discipline: with the exception of 2008 and 2011, this has been the weakest year for equity risk-adjusted returns in the past decade.

Positive on global equities for 2016
Our outlook is positive for three reasons.

First, the global economy is likely to improve this year. Accelerating consumption in developed markets, and greater stability in the emerging markets should allow companies to grow revenues more easily in 2016 than in 2015.

Second, while the Fed and Bank of England are both likely to increase interest rates, they will do so only gradually, keeping refinancing costs low. At a global level, monetary policy remains exceptionally loose, with the Bank of Japan and European Central Bank both engaging in quantitative easing programs.

Finally, the outlook for corporate profits remains good. With revenues increasing, refinancing costs low, and wage and commodity price pressures still relatively muted, we expect global profit growth of 4–9% to drive equities up in 2016.

Prepare for a bumpy equity ride
This year has demonstrated the volatility inherent in the equity market, and shown why investors should be cautious about overexposure to the asset class, despite our generally positive stance.

We see a number of risks in 2016.

First, uncertainty is evident from the 3Q sell-off about the outlook for China and the emerging markets. Even though China's overall growth came in ahead of expectations, changes in the composition of growth and in capital flows have meaningful consequences for its trade supply chain, particularly in EM.

Then, there are risks in central bank policymaking. The jury is still out on the potential impact of higher interest rates in the US, although we anticipate a rather slow and shallow Fed tightening cycle relative to history.

Next are political risks. The US presidential election, uncertainty over European unity sparked by the migrant crisis, questions over the UK's status in the EU, geopolitical rumbling in Russia and the Middle East, and elections in Japan could bring unpleasant surprises.

Inflation remains an outside risk. Corporate profitability has been strong in recent years, due in part to weak commodity prices and muted wage growth. A recovery in both could compress corporate profit margins and lead to questions about market valuations.

Region	Position	Returns		Valuation			EPS growth	
		2014 (%)	2015 (%)	Trailing P/E (x)	20-year median (x)	Dividend yield (%)	2015 (%)	2016 (%)
EM	N	-2.0	-10.1	12.6	12.9	3.0	-4–0	2–6
EMU	O/W	+5.6	+14.2	23.9	15.8	3.1	10–14	8–12
Japan	O/W	+9.9	+14.6	16.9	21.3	1.9	13–17	2–8
Switzerland	N	+11.5	+0.6	17.6	17.7	3.2	-2–2	6–9
UK	U/W	+0.8	-1.1	29.4	14.3	4.3	-17–-13	0–5
US	N	+13.4	+3.4	19.4	17.4	2.1	0–2	6–10
World*	**O/W**	**+4.9**	**+0.3**	**18.4**	**16.9**	**2.6**	**0–4**	**4–9**

* World returns are in USD. Note: N = neutral; O/W = overweight; U/W = underweight.
Source: MSCI (all indices), UBS, as of November 24, 2015

US
Neutral

Flat, flat, down, up for US equities in 2015
One might easily mistake a chart of the S&P 500 in 2015 for a map of the state of Florida. The market was broadly flat for the first half of the year, with weak earnings growth constraining upside, while generally decent economic growth and still-loose monetary policy protecting against downside. This was followed by the biggest weekly sell-off in almost four years in August, on concerns about the potential impact of an economic slowdown in China. Following a sharp rally in October, at the time of writing the market is not too far off from all-time highs.

Consumer discretionary, technology, and healthcare have led the market, while commodity-exposed energy, materials, and utilities have dragged.

Earnings growth acceleration to drive US equities
Aggregate S&P 500 earnings disappointed in 2015, with little to no growth. But stripping out the energy sector, S&P 500 earnings rose mid-to-high single digits. We expect 8-9% earnings growth in 2016 as the US economy gains some momentum and the headwinds from lower energy – and the strong dollar – fade. This acceleration should drive the market higher in 2016.

Economic growth remains relatively good, with consumer spending boosted by steady labor market gains and improving household balance sheets. We also expect capital spending to have a better year in 2016, with the drag from weak energy-related capex fading, and business spending on manufacturing and technology gaining pace.

US equity risks from the Fed, EM, inflation, and politics
We highlight a number of risks to the US market for 2016. First, equities will be potentially vulnerable to a faster-than-expected path of interest rate hikes by the Fed. US equity valuations are not cheap, and upside surprises to inflation could lead the Fed to hike rates aggressively, affecting valuation multiples negatively.

Second, upside surprises to inflation could have a compound effect if they filter through to wage growth. We note that corporate profit margins of 9.1% are at cycle highs and could be vulnerable if we see sharply higher wages, particularly for the labor-intensive consumer discretionary sector.

Third, as proved last August, US equities are not immune to negative sentiment from EM downside surprises, even if economic links are relatively small.

Finally, 2016 is an election year. While a Democratic president would likely maintain the status quo, a Republican winner could attempt to make a number of policy changes. This difference in stances creates policy uncertainty, which could affect the markets.

We hold a neutral tactical asset allocation position on US equities. We believe that the bull market cycle remains intact, but that other markets, such as the Eurozone and Japan have a more favorable outlook, given greater scope for near-term earnings gains.

Opportunity in US tech
Within US equities we prefer the technology sector.

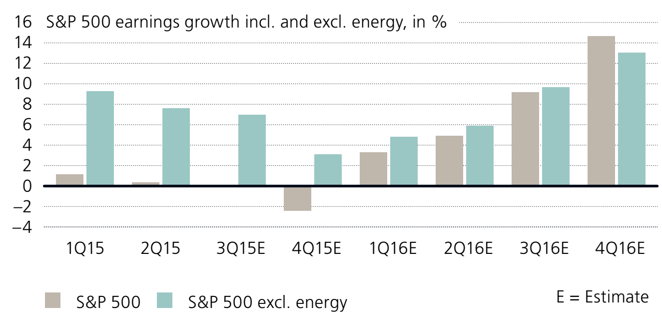
The technology sector has steadily outperformed the S&P 500 since mid-2013, and was also a leading sector in 2015. We expect the sectors' market leadership to continue.

Valuations are attractive in our view. Over the past 25 years, the sector has traded on an average premium of 20% over the rest of the market, but today is trading in line with the market, given widespread skepticism that earnings growth can be sustained. We believe that earnings can go on rising in 2016, due to higher levels of business spending, and secular growth trends such as cloud computing, mobility, cyber security, online advertising, and big data.

The sector is also aggressively returning cash to shareholders, which should continue in 2016, given strong free cash flows and balance sheet strength. Aggregate technology sector cash is currently a massive USD 500 bn.

Fig. 11

US earnings to get a boost from stable energy prices and USD



Source: UBS, as of November 13, 2015

Eurozone
Overweight

An eventful 2015 for Eurozone equities
The announcement of quantitative easing by the ECB in January stimulated a more than 20% rally in just three months, further fueled by depreciation in the euro, and flows from bond holders discontent with negative yields.

This was followed by a steady sell-off through 2Q, on concerns over the impact of a global bond market sell-off and subsequent fears of a Greek exit from the Eurozone. This accelerated through 3Q on uncertainty over exposure to emerging markets, from which Eurozone companies derive 30% of their earnings. The MSCI Eurozone Index came within a whisker of entering an official "bear market" by September.

A sharp rally in the fourth quarter has left the market still shy of its peaks, but nonetheless up by about 15% year-to-date. Consumer and healthcare stocks have outperformed, while resources, utilities, and energy have lagged.

Eurozone earnings boost
We hold an overweight position in Eurozone equities in our tactical asset allocation as we enter 2016. Companies are benefiting from low refinancing costs, the euro is historically weak against major trading partners, profit margins have room to expand, and loose monetary policy is prevailing.

We believe that EUR weakness could help Eurozone exporters on a trade-weighted basis; corporate debt refinancing costs are low, helping corporate net profit margins, and domestic demand is improving, boosting revenue growth. Overall, we expect earnings growth of 8–12% in the coming 12 months, which is superior to other regions.

The improved profit margins in recent months are encouraging. Net profit margins have edged up to 4.2%, well short of the cycle peak of 7.3% reached in 2008. If margins continue improving, this would suggest scope for durable upside in Eurozone equities.

The ECB may loosen monetary policy even further, as recent statements suggest, cutting interest rates or extending the duration of quantitative easing, or at least maintaining loose policy for the foreseeable future. The likely effects: a weaker euro, lower borrowing costs, and looser lending standards from banks to business should all help boost Eurozone equities.

Eurozone volatility, as usual
While we are positive on Eurozone equities as a whole, investors should be cautious about over-allocating to the region.

First, from a purely technical perspective, Eurozone equities are more volatile than most other developed markets. Over the past year, average volatility for the MSCI Eurozone equity index has been 20.4%, compared to just 11.8% for the MSCI World equity index. There is no reason to suggest that this will change in 2016.

Second, as we saw through the third quarter, the Eurozone is exposed to uncertainty over emerging market growth – 30% of Eurozone corporate earnings are derived from the region.

Finally, as always in Europe, politics will be a risk. Security will be an important concern, following the Paris terrorist attacks, and investors will need to watch for the possibility of Italian elections, or any return to political strife in Greece. The ongoing migrant crisis is likely to test European unity, and Eurozone equities are also unlikely to be immune from any uncertainty surrounding the UK's future status within the European Union.

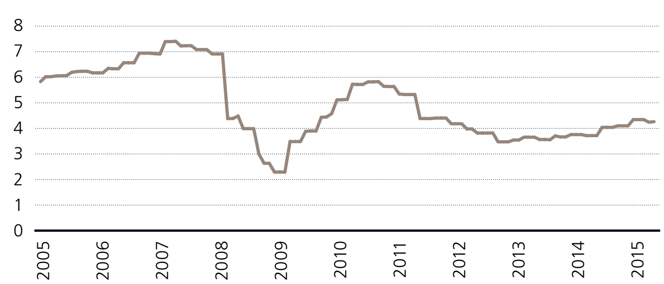
Opportunities in Eurozone energy and financials, and in Italy
Our preferred country within Eurozone equities for 2016 is Italy.

The Italian economy surprised to the upside in 2015, and recent bank surveys suggest that lending standards are loosening – something which should be positive for both growth and banking sector profitability. Financials make up 42% of the Italian equities market index, and we expect above-average earnings growth for the next two years.

Fig. 12

Relatively low margins suggest potential for durable upside

Eurozone EBIT margins



Source: Datastream, UBS, as of November 13, 2015

Emerging markets

Neutral

2015: A year too soon for EM equities
After an uneventful first quarter, there was actually some optimism about emerging markets by the start of the second quarter. The bubble in Chinese mainland equities had begun to spill through into other markets, and EM equities rallied by more than 10% in March–April.

Unfortunately, this proved premature, and a combination of political crisis in Brazil, the prospect of higher US interest rates, the bursting of the Shanghai bubble, and a further decline in commodity prices created a perfect storm for EM equities in the third quarter of the year.

The defensive healthcare and consumer staples sectors held up relatively well, but utilities, materials, and financials have all performed poorly.

Much negativity about emerging markets is priced in
Valuations of EM equities are now relatively attractive, in our view. On a price-to-book ratio of 1.4x, EM valuations are comparable with the lows reached last in 2003 and 2008, and a price-to-earnings ratio of 12x puts EM at a 30% discount to developed markets.

Furthermore, we believe that investor expectations for the region are now sufficiently low that emerging markets could be prone to rally in 2016 on incremental positive surprises. We note that investor positioning in EM has now normalized – global investors hold an average portfolio weighting of 15.6% in EM, down from 17.3% at the peak.

After holding an underweight position on emerging market equities for much of 2015, we have recently moved to neutral. We believe that after years of underperformance against developed markets, enough negativity may now be baked in to allow for better performance in the future. That said, we acknowledge that there are still obstacles to overcome.

EM still facing hurdles
Despite attractive valuations, we note that over a one-year time horizon, valuation alone rarely catalyzes performance, and EM will face a series of challenges in 2016.

First, while we expect economic growth to stabilize in 2016, it is likely to remain subdued. Private sector deleveraging will need to continue, Russia and Brazil are likely to remain in recession, and we expect China's growth to slow even more sharply in 2016 than it did in 2015.

Second, high US interest rates or any USD strength resulting from a US interest rate hike could cause problems for those emerging markets reliant on USD funding.

Third, earnings growth is still poor. Profits have fallen by 30% since the peak in 2011, and we believe that consensus earnings growth expectations (9% for 2016) may be too optimistic. We expect 2–6%; lower than for other regions.

Finally, there are still a number of idiosyncratic risks which could impact the market, including, but not limited to, the political situation in Brazil, and geopolitical risks in Russia and the Middle East.

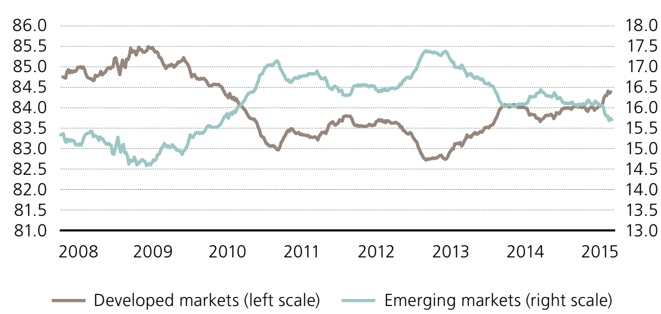
High quality EM dividend yielders
Although we expect emerging market growth to stabilize in 2016, it will remain muted. In this environment, we believe the market is likely to reward companies which return cash to shareholders, rather than rely on potentially questionable future growth.

Despite the very poor performance of emerging market equities in recent years, such stocks would have delivered returns of around 20% over the past two years, a trend of outperformance we expect to continue in the year ahead.

Fig. 13

Investors have lost faith in EM in recent years

Value-adjusted portfolio allocations, % of total bond and equity allocations



Note: Value-adjusted portfolio allocations adjust the changes in market value, so that the allocation does not drop off solely because the market fell.
Source: Bloomberg, UBS, as of November 13, 2015

Japan
Overweight

Japanese equities undone by a quarter
By the halfway point in 2015, Japanese equities were among the world leaders, with the MSCI Japan up by around 15%. But a vicious sell-off over the course of six weeks from mid-August undid all of this.

Japan became an easy target for sellers: the country has close economic links to China, the yen (widely seen as a "safe haven" in times of market turbulence) appreciated, affecting the outlook for exporters' earnings, and investors were growing frustrated with the Bank of Japan's reluctance to increase its stimulus package, despite evidence that the Japanese economy was failing to respond to current measures.

The fourth quarter rally has seen Japanese equities resurge; they are up 13% for the year at the time of writing. The healthcare, consumer staples and utilities sectors have each delivered more than 20% performance, while materials and energy are the only sectors in negative territory for the year.

Policy boosts for Japan
As we enter 2016, we hold an overweight position in Japanese equities, which should benefit from improving profitability, and a range of policy initiatives to boost growth and the market in 2016.

Prime Minster Shinzo Abe's so-called "Three Arrows" of monetary easing, fiscal spending, and structural reform have been critical to the relative success of Japanese equities over the past three years. Since October 2012, when "Abenomics" was first mooted, Japanese equities have outperformed global equities by a massive 90% in local currency terms.

We expect such policy-driven positives to continue in 2016.

First, we believe the Bank of Japan could expand its monetary easing program in an attempt to stave off deflation. This could include a significant expansion in its direct equity purchases. It currently buys JPY 3 trn each year.

Second, we believe the Government Pension Investment Fund (GPIF) is likely to increase its investment in the Japanese equity market. We expect the GPIF to buy JPY 90–120 trn in equities over the next one to three years.

Finally, the country's revised corporate governance code should lead to higher return on equity at Japanese companies, and more cash returned to shareholders.

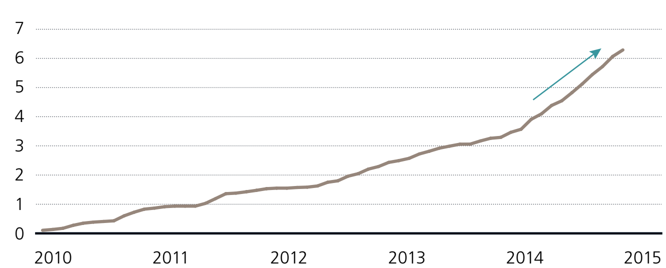
Uncertainty ahead in the Japanese Diet
A key risk to the heavily policy-driven Japanese market is the expected upper house election in July 2016. Prime Minister Abe, the key instigator of pro-market policies, has seen his popularity drop below 40% in the most recent polls, after the enactment of unpopular national security bills.

We expect a focus on more business-friendly measures in 2016 to try and win back support. However, a potential defeat for Abe's party in the upper house represents a key risk for Japanese equities in 2016. Despite the various positive factors for the market, investors should be wary about overexposure to Japanese equities.

Top Japanese equity picks for 2016
We like stocks that are conducting share buyback programs. The change in the Japanese corporate governance code is encouraging companies to unwind cross-shareholdings, unlocking cash for shareholders. While this occurred more slowly than expected in 2015, we think it will accelerate in 2016, with Abe stating that "corporate governance reform is atop my agenda." In any case, buybacks are already up 56% year-over-year in 2015, and those companies announcing buybacks have outperformed the wider market.

We also believe that Japanese auto manufacturers could be one of the best positioned sectors within the Japanese equity market in 2016. With the emissions scandal affecting automakers in Europe, and movement toward a Trans-Pacific Partnership agreement, Japanese auto makers are well positioned to take advantage of tighter emission controls and energy-saving regulations.

Fig. 14
The Bank of Japan is buying equities
ETFs held by Bank of Japan (JPY, trn)



Source: UBS, as of November 13, 2015

UK
Underweight

Another year treading water for UK equities
After a decent first quarter in 2015, the UK market began suffering in the second quarter due to its relatively high exposure to the materials and energy sectors, as commodity prices fell. The relatively defensive nature of the market meant that it outperformed other more cyclical markets through the 3Q sell-off. However, the unfavorable sector mix meant the damage had already been done. Despite a rally in the fourth quarter, UK equities are still down by around 1% year-to-date.

Underweight UK equities on weak earnings growth
We have an underweight position on UK equities.

The UK market has delivered a negative total return in the past two years, but we do not believe it is the time to count on a rebound. The market lacks the earnings momentum usually associated with a sustainable rally: earnings are likely to end the year down by more than –13%, after –4% in 2014. Furthermore, we believe that the full effects of weaker commodity prices are yet to be factored in by consensus, and expect further earnings downgrades over the coming months.

A further headwind to earnings comes from the relative strength of the British pound. While the pound is becoming less of a drag on earnings than it was last year, the UK does not benefit from a currency tailwind as do the Eurozone and Japan. The GBP has strengthened about 10% relative to the euro and traded sideways relative to the USD this year.

Benefits of the UK market in a portfolio context
Despite our underweight stance on UK equities, we still recommend that investors consider the merits of a long-term holding in UK equities.

In 2016, it is worth considering the possibility of a rebound in the commodity/EM complex, which could have an outsized benefit for UK equities. China accounts for around 10–15% of UK equity market revenues, and EM total approximately 35%.

Furthermore, although UK equities have a relatively high weighting in the commodities and energy sectors, the mix of the market is generally relatively defensive: over the past five years, it has demonstrated a "beta" of around 0.9x to the global market. While this means it is likely to underperform in our base case scenario of rising markets, it should be expected to outperform other developed equity markets in the event of a sell-off, in particular any sell-off driven by concerns over developed market growth. This kind of diversification is very valuable in a long-term portfolio context.

We look for UK value to outperform in 2016
Within UK equities, we believe that the market is most likely to reward "value" companies with low valuations and high dividend yields in comparison to the rest of the market.

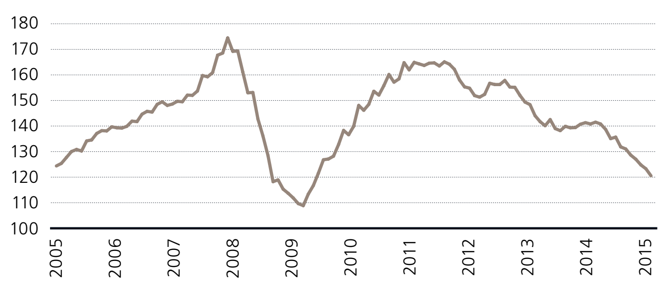
Along with the US, the UK economy is relatively deep into its economic cycle. We believe 2016 will see the Bank of England hike interest rates (in May, in our base case scenario) and that 2016 will also see 10-year gilt yields rise.

In an environment of rising 10-year yields, and ahead of an interest rate hike, we believe that value stocks will outperform, given that investors may be more reluctant to pay for growth at a time when discount rates are rising. While in the US, our strong overweight of the "growth-centric" IT sector keeps us agnostic between US growth and value segments.

Fig. 15

UK earnings are under pressure

IBES trailing earnings MSCI UK



Source: Thomson Reuters, as of November 13, 2015

Switzerland
Neutral

Swiss resilience through shocks
January 2015 saw a 15% peak-to-trough drawdown in Swiss equities after the Swiss National Bank removed its cap on the Swiss franc, but by the end of the first quarter, Swiss equities were trading up for the year thanks to a steady weakening in the currency against the US dollar, and surprisingly resilient corporate profitability.

The Swiss market saw a second sell-off in August on global concerns about EM growth (from which Swiss companies source one-third of their earnings), but the relatively defensive sector makeup of the Swiss market meant that it outperformed other global peers.

It has participated in the global fourth quarter rally, but to a lesser extent than other, more cyclical peers. The market is underperforming the global market year-to-date, but flat performance is impressive in the circumstances.

Consumer staples and finance have outperformed the wider market, with consumer discretionary the key drag on performance.

Strength of the Swiss franc dragging on Swiss equities
The sudden appreciation of the Swiss franc in January sent Swiss equities down 15% from their peak.

It exemplified the importance of currency movements for the highly international Swiss equity market, which derives around one third of profits from Western Europe, one third from the emerging markets, and one quarter from North America.

With the Swiss franc having appreciated against key trading partners (in particular in Europe and the emerging markets), sales growth is suffering and has shrunk in Swiss franc terms.

The currency drag should fade in 2016, but we believe investors should be prepared for near-term earnings disappointments, and limit overexposure to Swiss equities.

Swiss earnings to improve in the medium term
Although currency strength is leading to near-term earnings disappointments, Swiss companies are showing resilience, and in local currency terms sales growth is rising moderately. We believe the Swiss franc is unlikely to appreciate too much against the euro in 2016, and would expect the Swiss National Bank to intervene to prevent a sharp appreciation.

As such, we could expect earnings growth to pick up in the medium term, and believe that Swiss equities can represent a resilient and profitable part of long-term equity portfolios.

Dividends also remain an important part of the total return of Swiss equities. After a majority of companies increased their dividends in 2015, we expect overall dividend payments to be raised again in 2016.

Opportunity in Swiss high quality dividend payers and mid caps
Within the Swiss equity market, we like Swiss high quality dividend payers, and mid caps.

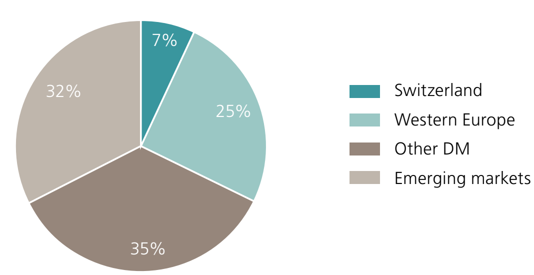
In 2015, the end of the Swiss franc currency cap against the euro brought with it a new era of negative interest rates in Switzerland, with the Swiss National Bank charging –0.75% p.a. on deposits held there. In our view, this increases the attraction of high quality dividend payers – companies with sustainable earnings, high returns, and a history of raising dividend payments to investors.

By segment, we also prefer the Swiss mid caps, which have a) historically offered earnings and dividend growth superior to large and small caps (more than double the earnings growth over the past decade), b) stronger balance sheets (47% have net cash positions), and c) attractive valuations, at a premium of just 5% to the wider market, below the long-term average of 12%.

Fig. 16

Swiss equities are heavily exposed to foreign earnings

SMI by estimated operating profit contributions



Source: UBS, company data, as of November 13, 2015

APAC

A difficult year for Asia ex-Japan
Investors in Asia ex-Japan equities had it tough this year.

After a decent start to the year, thanks to strong performance from Hong Kong equities in particular, the market began to sell off from April onward. With local exchange rates falling, in particular in South East Asian economies such as Malaysia, Indonesia, and Thailand, returns were under pressure. Equities in Singapore, Indonesia, and Taiwan have also delivered weak performance due to concerns about the real estate market, commodity prices, and exposure to a global growth slowdown respectively.

At times it felt like 1997 all over again. But as we head into 2016, we are maintaining an overweight stance in Asia ex-Japan equities, in the context of an Asia focused portfolio. We believe the sell-off was unwarranted, given that macro fundamentals are much more robust now than they were in 1997. Flexible exchange rates limit the risk of storing up a future crisis, labor markets remain robust, and real estate values, while falling, are not collapsing.

Low valuations to prove a support for Asia ex-Japan
The region's equities trade on a price-to-book ratio of 1.4x, close to levels last reached at the 2008 lows.

Of course, revenues are likely to stay under pressure. Growth in the region is likely to slow again in 2016, with China slowing even more rapidly in 2016 than in 2015 on our base case forecasts. As this year demonstrated, sentiment is also likely to remain fickle.

However, companies are beginning to successfully adapt to a time of lower revenue growth, reducing their fixed-cost bases and adjusting capital expenditure plans. This could mean that free cash flow generation is poised to surprise on the upside, even if revenue growth remains disappointing.

Global opportunities in APAC
With growth in Asia expected to slow again in 2016, we advocate a focus on companies in the region that are tapping overseas growth opportunities.

For instance, in Hong Kong, the weakening real estate market is a headwind for both the economy and the equity market index. Retail sales in Hong Kong itself have declined for two consecutive years. We think companies with global exposure should generally see higher levels of earnings growth than those with domestic exposure.

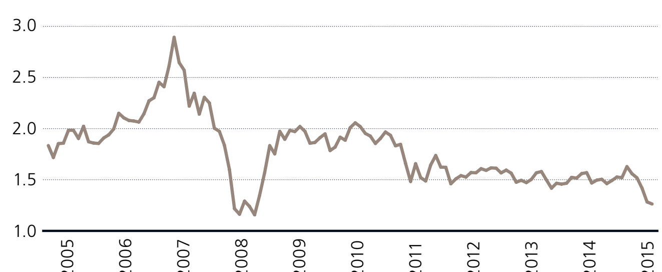
In Singapore, economic restructuring is posing domestic idiosyncratic risks, but the relatively weak Singapore dollar creates opportunities for exporters and globally exposed companies.

And in China, we believe investors could benefit by seeking exposure to the many companies expanding overseas amid uncertainty about the outlook for the domestic economy.

Fig. 17

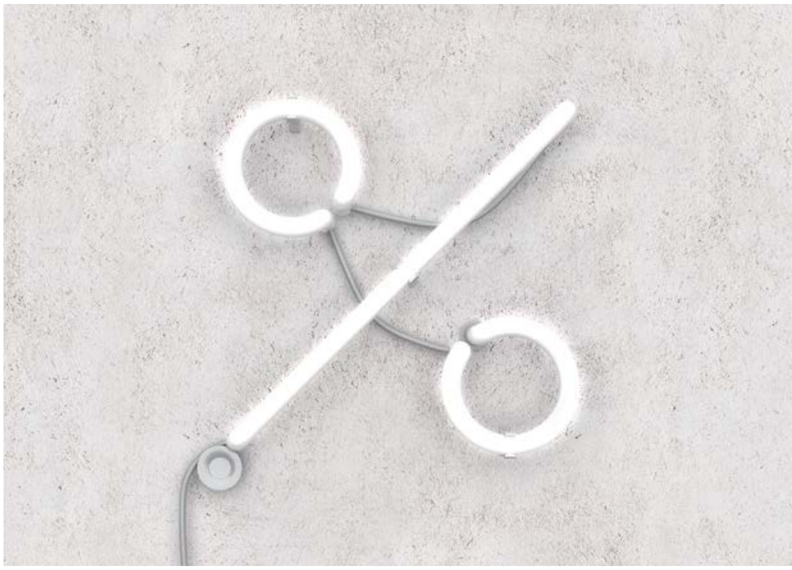
Asian equities are trading near trough valuations

MSCI Asia ex-Japan price-to-book ratio (x)



Source: Bloomberg, as of November 13, 2015

Bonds



Leslie Falconio, Senior Fixed Income Strategist
Barry McAlinden, Senior Fixed Income Strategist
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Douglas Rothstein, Head of Rates Strategies
Philipp Schoettler, Head of DM Credit Strategies
Michael Bolliger, Head of EM Asset Allocation

As the world transitions to a moderately higher pace of growth, higher levels of inflation, and higher interest rates in the US, we expect bond yields to rise. In a difficult environment for bonds, we underweight the asset class as a whole, but see opportunities within investment grade corporates.

2015 bond market review
Investment grade bonds had a relatively volatile year. Third-quarter performance was weaker than might have been expected in a risk-averse market. US investment grade corporate bonds, in particular, faced technical headwinds from record net issuance, but signs of the US Federal Reserve deferring interest rate hikes supported prices through the latter part of the year. At the time of writing, returns are broadly flat.

Meanwhile, it looks set to be a broadly flat year for US high yield credit returns too. Good performance in the first half, aided by a recovery in oil prices, turned weaker in the third quarter, when falling energy prices and concerns about global growth affected economically sensitive bonds.

We are underweight bonds
We are underweight bonds relative to equities in our tactical asset allocation.

Yields on the safest bonds remain very low, and we are facing a year in which the Federal Reserve is likely to be increasing interest rates. In our base case, we expect US Government bonds to return –1.2% to –1.3% over the next six months.

Higher rates are likely to limit returns for investment grade corporate bonds too (1 to 2%). The outlook for riskier high yield credit is better, but returns are likely to be limited to current yields as rising rates and an increase in defaults offsets the positive impact of narrower spreads.

Focus on credit for the year ahead

We believe that credit should perform relatively well in 2016, and is the most appealing segment of the bond market, in our view. We overweight investment grade corporate bonds.

The economic backdrop of decent but uninspiring growth should generally support credit as an asset class. Growth is too low to drive materially higher interest rates, but still high enough to allow for spreads to compress, and to prevent a significant increase in defaults.

Yields to move higher

We expect to see yields move higher in the year ahead.

Although structural demand for government bonds will persist, higher interest rates in the US are likely through 2016. The US economy will continue to expand with a continued rise in growth and inflation. Against this backdrop, we expect yields to move higher in 2016. We are forecasting a 2.5% yield on the 10-year US Treasury.

Duration

5–7 year maturity focus

In an environment of rising bond yields it can be tempting to shift bond portfolios to short-dated bonds, or to hedge interest rate risk completely through fixed for floating swaps. While we see tactical opportunities in shorter-maturity investment grade credits, we continue to believe that investors should seek an average maturity range of 5-7 years within portfolios over the long term, even as we transition toward a higher yield world.

We think that a 5-7 year average maturity achieves the best balance between providing an adequate return and insulating the remainder of the portfolio against shocks.

Government

US Government bonds to underperform equities

With yields set to rise, we believe that the highest quality bonds are likely to underperform both equities and lower quality bonds in 2016.

We expect total returns of -1.2% for 5-7 year US Treasuries over the next six months.

Might US government bonds rally yet again?

Although we expect to see higher yields and poor performance for US Government bonds in our base case, we have to acknowledge that this has been just about the single most popular prediction by investment strategists in recent years. Still, US interest rates have consistently confounded expectations.

The fragility of this economic expansion, caution about increasing interest rates among central banks generally, and structural deflationary pressures, including overcapacity in China and technological shifts, mean that it is quite possible that US Treasury yields will defy the odds again.

So while our base case remains for higher yields, we believe it would be unwise for investors to position too heavily in this direction. The outlook is less favorable than in the past, but US high quality bonds should still have an important role in most portfolios.

	2014 returns (%)	2015 ytd returns (%)	Yield (%)	Current credit spread (bps)
	2014	2015 ytd		Current
US government bonds (5-7y)	4.57	2.03	1.86	N/A
US IG corporate bonds	7.46	-0.07	3.51	155
US HY bonds	2.51	-2.12	8.05	635
US municipal bonds	9.70	2.50	2.36	9
EM corporate bonds	5.70	2.90	5.99	386
MBS	6.07	1.31	2.57	103
Preferreds	15.93	7.18	5.07	111
TIPS	4.49	-0.93	0.56	N/A

Source: Bloomberg, UBS, as of November 23, 2015; US Government: BAML US Treasury (5-7yr) Index; US IG corporate: Barclays US Aggregate Corporate Index; US HY bonds: US High Yield Master II Constrained Index; US municipal bonds: BAML Municipal Master Index; EM corporate bonds: JPM CEMBI Diversified Index; MBS: BAML US Mortgage Backed Securities Index; Preferreds: BAML Core Plus Fixed Rate Preferred Index; TIPS: BAML US Inflation-Linked Treasury Index

Investment grade corporates

Positive on corporate bonds
We hold an overweight position in corporate investment grade credit as we head into 2016. In 2015, credit spreads were driven to their widest level since 2012, but we attribute this to technical, rather than fundamental factors.

Against a backdrop of decent developed market economic growth, current credit spreads of 155bps are attractive.

Rising rates a risk to longer-dated corporate bonds
The low interest rate environment of recent years has encouraged many companies to try and lock in low borrowing costs far into the future. They have done this by issuing long-dated bonds into the market. The average maturity on newly issued US investment grade bonds has more than doubled in the past decade (from 8.6 years in 2005 to 17 years on average by 2015).

We are generally cautious on the outlook for these long-dated investment grade bonds, especially 10+ years, and recommend that investors ensure they are not overexposed to the segment.

Strong issuance, and rising rates volatility has already affected these longer-dated bonds, and we continued underperformance, as investors sell interest-rate-sensitive, safe fixed income assets in favor of shorter-dated credit, equities, or cash. Even if long-dated bonds can go on defying the odds and remain well supported in 2016, we believe that the high volatility inherent in such long-dated issues is generally not sufficient to justify the risk of mark-to-market losses by holding them.

High yield

US high yield bonds still remain attractive
As part of a long-term strategic portfolio, US high yield bonds still remain attractive – offering an 8.2% yield to maturity with a volatility that is about half that of the S&P 500. The market also has a history of recovering swiftly from setbacks. It took US HY just eight months to return to its previous peak following the 2008 crisis, compared to about four years for the S&P 500.

The recent bout of risk aversion has left US HY trading at a relatively generous 635bps spread over equivalent government bonds, against an 18-year average of roughly 500bps. We believe this will fall back to 525bps as investors recover their appetite for risk assets over the coming six months.

The coming high yield default cycle?
While we believe most investors should maintain some strategic exposure to US high yield bonds, we believe that default rates are likely to rise in 2016, which could put some pressure on the asset class.

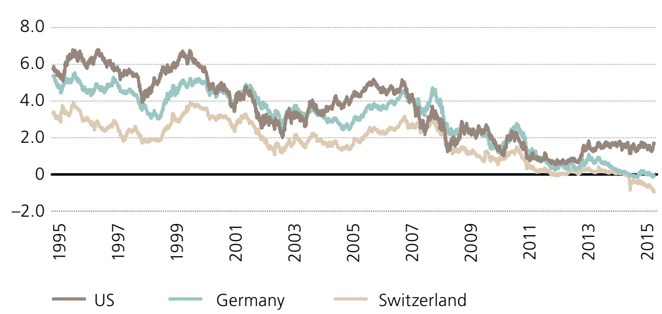
The US credit cycle is at a relatively mature stage. New bond issuance is being increasingly used for capital investment or for acquisitions. While this is potentially good for overall economic growth, it tends to be bad for credit quality, as it increases corporate leverage. Corporate leverage has risen from 3.2x net debt to EBITDA in 2010 to 4.9x this year.

This, along with the recent commodity price weakness depressing the cash flows of companies in extraction industries, we expect to see US high yield default rates rising toward 4.5% over the next 12 months.

Fig. 18

Yields have slid lower and lower

5-year government bond yields (%)



Source: Bloomberg, UBS, as of November 13, 2015

Emerging markets

EM bond fundamentals under pressure

While we expect more stable growth for emerging markets in 2016, rates of growth are lower than in the past, structural reforms are necessary, and private sector deleveraging still needs to take place in many countries. As such, investors should remain cautious about investing in sovereign bonds or corporate credits of EM issuers.

With corporate profitability under pressure, we expect the EM corporate default rate to rise in 1H 2016 as weaker EM currencies, low commodity prices, and subdued growth dynamics continue to eat into EM corporate cash cushions. Sovereigns might fare better, but have their own vulnerabilities too, as demonstrated by Brazil's recent credit rating downgrade to sub-investment grade status.

Emerging market sovereign bonds also have a relatively long duration in general, and so could be more vulnerable than other bond segments to higher US interest rates.

Is the EM weakness priced in?

While there are plenty of good reasons for caution on EM debt, we believe that corporate and sovereign spreads may already reflect weaker fundamentals to a large degree. Credit spreads have widened in recent months, to 390bps for a diversified basket of sovereign and corporate names.

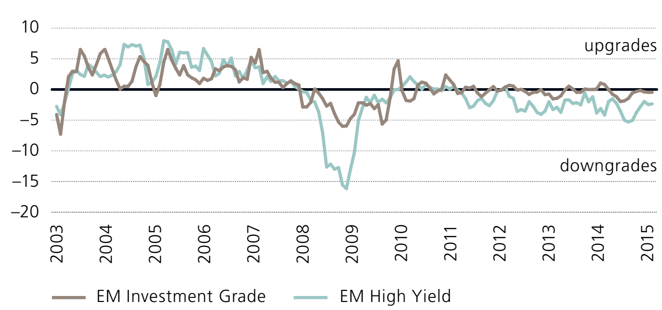
Even though 1H 2016 may be turbulent, we expect aggregate EM growth to stabilize next year. Stabler commodity prices might also help some of the most vulnerable issuers.

We are therefore holding a neutral stance as we enter 2016, and maintain a strategic exposure to the asset class. Attractive yields balance the uncertain fundamental backdrop in the region.

Fig. 19

Emerging market credit ratings are under pressure

Rating migration, EM investment grade and high yield



Source: Bank of America, UBS, as of November 13, 2015

US fixed income

Municipals

Demand will remain consistent

In 2015, municipal securities showed stability, posting a modest positive return. For the year ahead, we believe demand for munis will remain reasonably consistent as investors continue to seek refuge from high marginal tax rates. Municipal bonds should outperform US Treasuries in a rising rate environment.

Careful credit selection is essential

We expect most state and local governments to exhibit stability in their credit profiles over the next 12 months, but there will be some notable exceptions. Defaults on Puerto Rico bonds and wider credit spreads in New Jersey and Pennsylvania are probable. Careful credit selection is essential. We are underweight municipal bonds.

MBS

Fed move will not largely impact MBS spreads

MBS was the second best-performing asset class within taxable fixed income in 2015. We moved to an overweight in mid-year and recently scaled back to neutral as other high-quality asset classes lagged in 2015. We believe that the Fed will gradually lower its balance sheet 8 to 12 months after the first rate hike. We don't anticipate a large impact on MBS spreads; however, the shift to a newer monetary policy may cause short-term volatility.

IG corporates should outperform MBS in 2016

Our recommendation to diversify into CMBS versus investment grade corporates has worked well as CMBS has returned 1.20% while investment grade corporates are down 0.38%, year-to-date in 2015. We look for IG corporates to outperform versus all MBS sectors in 2016.

Preferreds

Performance in 2016 could be more challenging

Preferred securities have posted mid single-digit returns in 2015, which is good performance on an absolute basis. However, the sector has dramatically outperformed relative to other major sectors, which have struggled due to rate and spread volatility, as well as technical supply issues. In 2015, spread compression acted as a "shock absorber" to periodic rate spikes – cushioning the impact and driving performance higher. Performance in 2016 could be more challenging given the likelihood of higher sustained rates and greater rate volatility, as well as the current level of spreads, which leaves limited prospects for further compression. We are neutral on preferreds.

Preferred spreads to remain resilient

We expect preferred spreads to remain resilient as rates gradually rise. Still, we could see periods in which spreads will rise with rates, resulting in pricing pressure. Therefore, we favor defensive structures within the preferred securities universe, including: 1) fixed-to-floating rate coupons with high reset spreads, or 2) high fixed-rate coupons with call protection, but relatively near-term call dates.

TIPS

We are underweight the TIPS index

We are underweight the TIPS index as the long-duration component will outweigh the increasing inflation expectations as the Fed begins its hiking cycle.

We prefer 5-year TIPS over 5-year government securities

We prefer 5-year TIPs over 5-year government securities as the market has priced in a deflationary scenario due to the drop in oil prices and changes in growth expectations for China. We do not believe the US economy will fall into a recession, and therefore recommend 5-year TIPS over 5-year Treasuries, with an underweight to the overall TIPS index.

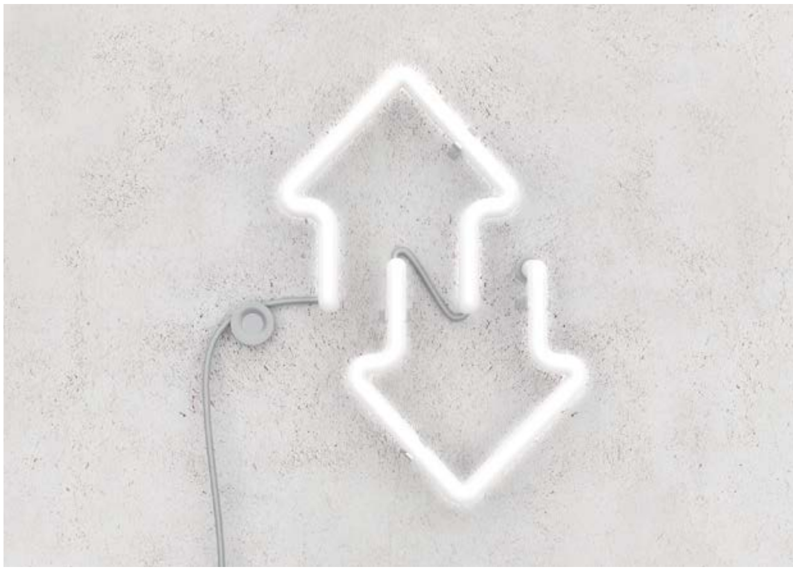
Fig. 20

5-year TIPS break-even Inflation underperformed in 3Q of 2015

5-year TIPS break-even inflation spread since 2009

Source: Bloomberg, UBS, as of 9 November 2015

Alternatives



Simon Smiles, Head of UHNW & Alternatives
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Karim Cherif, Hedge fund Strategist

As our world transitions toward one of lower return, alternative investments will play an increasingly important role in portfolios, in our view. For 2016, we think investors could benefit from diversifying assets in a well-balanced hedge fund portfolio across different strategies.

Hedge funds

A mixed year for hedge funds
2015 was relatively tough for hedge funds, amid weak returns from global equity markets and a number of idiosyncratic events affecting widely held individual stocks. At the time of writing, the HFRI Fund of Funds composite index is flat year-to-date.

Returns were driven in part by the third-worst year in a decade for equity markets. This affected the equity-hedge style in particular (flat year-to-date).

Macro funds started the year strongly, but suffered from April onward with the reversal of the long-running equity and government bond bull markets, and signs of bottoming in commodities (–1.5% year-to-date).

Event-driven funds also started the year well, but suffered the poor performance of some widely held companies in the health-care sector in August and September.

Opportunities in hedge funds
We believe that hedge funds can deliver more favorable risk-adjusted returns in 2016 than in 2015.

2016 should offer better circumstances for hedge fund managers as structural macroeconomic shifts such as monetary policy normalization in the US, ongoing monetary easing in Europe and Japan, and falling demand from China are likely to spur regions and sectors to diverge across asset classes.

This should offer trading opportunities but requires a more thematic and tactical approach to investing, and favors actively managed investment vehicles that can adapt more readily to changes. Normalizing volatility toward long-term averages should also create arbitrage opportunities that some managers can capture.

Generally, we expect returns of 4–6% in 2016 for the asset class as a whole.

A well-diversified portfolio investing in a range of managers with different styles and approaches to markets is the best way to benefit from hedge funds' unique investment capabilities.

Hedge fund risks for 2016
An environment of sharp and unexpected equity market corrections followed by V-shape recoveries is challenging for managers to navigate, as we have seen in 2015. Highly directional equity-oriented strategies, the returns of which are more dependent on market beta than on alpha, could be vulnerable in such an environment.

In the credit area, market depth and liquidity remain a potential issue. Managers focused on capturing illiquidity premiums in fixed income could face temporary risk in the event of a significant dislocation, though this is not our base case.

Private markets

Private markets in 2016
For investors who can tolerate illiquidity in a portion of their portfolio, private markets represent opportunities to deploy longer-term capital that can provide additional diversification as well as other potential benefits including inflation hedging. However, selectivity will be critical for investors looking to make new private market investments over the coming year. Dynamics such as low entry valuations and less competition that can represent return tailwinds earlier in the cycle, are unlikely to provide similar benefits in the current environment.

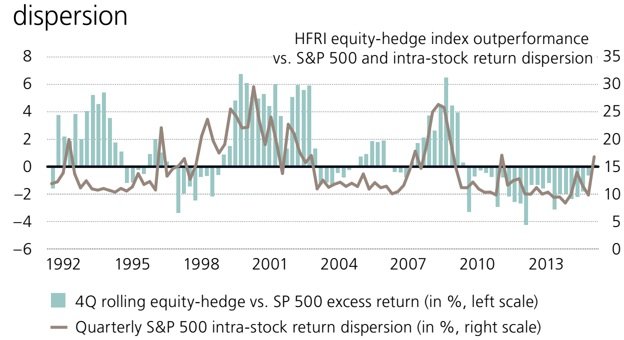
As a result, selecting the right strategies and managers will be of particular importance. We recommend investors consider long-term opportunities resulting from dislocations in areas currently out of favor in public markets; potential examples include energy and certain emerging markets.

Style	2014 return	2015 ytd return
Equity hedge	+1.8	+0.0
Event driven	+1.1	-1.7
Macro	+5.6	-1.5
Relative value	+4.0	+1.2
HFRI Fund of funds	**+3.4**	**-0.1**

Source: HFRI, UBS, as of November 17, 2015

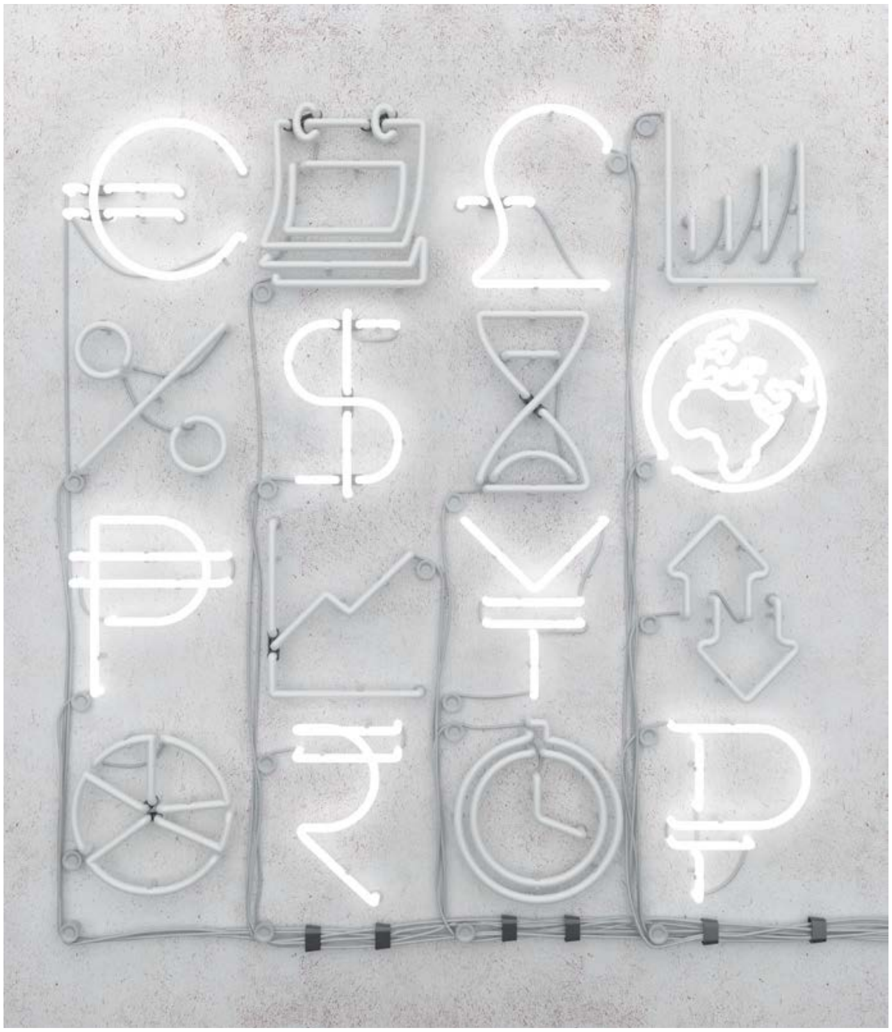
Fig. 21

Equity-hedge funds outperform in times of high dispersion



Source: Bloomberg, UBS, as of November 13, 2015

Currencies



Katie Klingensmith, Economic and Policy Strategist, Wealth Management Americas
Tom Flury, Head of FX Strategies
Constantin Bolz, FX Strategist

The US dollar is likely to remain strong for much of 2016, with the Fed increasing interest rates, but may be nearing the end of its run. Meanwhile, we expect short-term weakness for the euro as the ECB extends its loose monetary policy. The Norwegian krone and Canadian dollar should perform well in 2016.

US dollar – close to the end of the road

After a ca. 10% trade-weighted appreciation in 2015, the US dollar is at its strongest, on a trade-weighted basis, in more than a decade.

We believe that the strength of the US dollar will continue in 1H 2016. US unemployment is now sufficiently low that the Federal Reserve is likely to hike interest rates through 2016, while the ECB and Bank of Japan seem closer to easing than hiking.

That said, we believe that any appreciation surrounding initial interest rate hikes may conclude the USD's run. The USD's value looks stretched on a purchasing power parity basis (we think 1.25 against the euro is fair), and some Fed officials have expressed concern about the impact a strong dollar might have on exporters and inflation.

We forecast EURUSD to fall to 1.05 over the next three months, but rise back to 1.10 over the next 12 months.

Euro – easing to the bottom
After plunging more than 10% on a trade-weighted basis in the first quarter of 2015 after the European Central Bank announced quantitative easing, the EUR has been broadly stable through the year.

We expect another near-term downward step. The ECB presently has no incentive to restrain monetary easing. Unemployment is still high, and inflation is low. ECB President Mario Draghi recently indicated that near-term monetary policy could become even more accommodative.

Longer term, we believe that EURUSD would be near its bottom at 1.05. It is already around 15% undervalued against the USD and 10% against the GBP on a purchasing power parity basis, and over the long run the persistent low inflation that the Eurozone encounters should be positive for its currency.

British pound – still going
After another year of appreciation (+7% on a trade-weighted basis) in 2015, the British pound is at its strongest since 2008, when the banking crisis provoked a rapid decline.

We believe that the GBP will likely appreciate from here, in particular relative to the EUR. As with the US, the UK is poised for a normalization of interest rates. Solid GDP growth, a strong housing market and falling unemployment mean that crisis-level interest rates are no longer needed.

However, with no imminent inflation threat, and signs of moderately slower growth in the UK in recent months, the Bank of England is likely to be cautious. As such, the pound is unlikely to appreciate as strongly in 2016 as in recent years.

Swiss franc – after the cap
After dramatic appreciation in early 2015 after the Swiss National Bank abandoned its exchange rate floor against the euro, the CHF has been trapped in a narrower range against the EUR, and steadily weakened against other major currencies since.

We believe the franc is set for another year of range-bound trading against the euro in 2016. On the one hand, the Swiss currency is unlikely to depreciate against the euro while the European Central Bank is biased toward easing. On the other hand, while the Swiss economy has been relatively resilient in the face of currency strength, there have been signs of strain. SNB officials have hinted that they would seek to offset the impact of further ECB QE on the Swiss franc.

A EURCHF trading range of between 1.05 and 1.10 is likely for 2016, in our view.

The Japanese yen – modest further weakness
In 2015, the JPY has traded in a very tight range against the USD, appreciating overall by 3% on a trade-weighted basis through the year after sizable depreciation in prior years.

In 2016 we expect modest further weakness. Japanese monetary policy will remain conducive to keeping the yen weak, inflation has remained well below the government's target, and it is doubtful that it will reach this 2% goal in 2016, either.

But the scope for further depreciation is limited by the extent of the yen's slide over recent years. We estimate JPY purchasing power parity against the USD at 78, a significantly stronger level than today, and in the long run, as with the EUR, low rates of inflation should be favorable for JPY.

The other G10s
The Canadian dollar has suffered from the decline in the oil price, and is currently trading close to its weakest against the US dollar in more than a decade. We expect a more stable oil price in 2016, and Canada's currency is now undervalued against the USD.

Meanwhile, we expect the Norwegian krone to rebound significantly in 2016 as the economy recovers from the recent slowdown and the easing cycle approaches its end. Elsewhere, we believe the Swedish krona will remain range bound against the euro. The Riksbank is eager to avoid a harmful appreciation.

Selected currency forecasts

Currency	Spot	12m	PPP	Currency	Spot	12m
EURUSD	1.07	1.10	1.25	USDCNY	6.37	6.80
EURCHF	1.08	1.10	1.24	USDTWD	32.8	34.0
USDCHF	1.01	1.00	0.99	USDINR	66.0	68.5
EURGBP	0.70	0.70	0.77	USDIDR	13732	15750
GBPUSD	1.52	1.58	1.62	USDRUB	65.3	65.0
USDJPY	123	124	78	USDTRY	2.88	3.20
AUDUSD	0.71	0.65	0.69	USDZAR	14.3	13.9
USDCAD	1.33	1.22	1.22	USDMXN	16.8	16.0
EURNOK	9.29	8.50	9.49	USDBRL	3.83	4.30

Source: UBS, as of November 17, 2015

We have a negative outlook for the Australian and New Zealand dollars, given the slowdown in commodity demand from China, and the effect on key raw material and dairy prices. After 10% and 8% respective trade-weighted depreciations in 2015, valuations are now fairer, but we think there is scope for some further weakness in 2016 while commodity supply is cut back.

Emerging market currencies – under pressure again
After a particularly bad year for EM currencies in 2015, 2016 is likely to be better, but only moderately.

EM currencies tend to appreciate when GDP growth is strong and the gap with developed markets is large; when commodity prices are strong and rising; and when declining developed world interest rates push capital toward emerging markets.

For 2016, we expect EM GDP growth to improve, but only modestly (to 4.3% from 4.1%), and the gap to developed markets will stay relatively low (2.1%). Commodity prices look set to recover, but the revival will be modest and prior highs will not be regained. Finally, rising interest rates in the US will make it harder for emerging nations to attract capital.

As a result, we expect EM currencies to remain under pressure.

APAC – negative outlook
After a negative year for most Asia Pacific currencies against the USD in 2015, we retain our generally negative outlook on APAC currencies for 2016.

Events in China, which account for almost half of the region's economic output, will be influential. We believe the country is likely to continue cutting interest rates, if necessary, to prop up its economy, making the CNY less attractive, and potentially provoking other countries to follow suit. We expect the CNY to depreciate very slightly, trading at 6.8 by the end of 2016.

The most vulnerable currencies in the region are the Indonesian rupiah and the Malaysian ringgit. Indonesia's high inflation and current account deficit are structural negatives. Malaysia meanwhile has small and shrinking foreign exchange reserves, making it hard to support the currency if a crisis emerges, although a recovery in oil prices in 2016 would help.

Among the more attractive currencies is the Philippine peso. We expect the currency to be relatively more resilient in an environment of rising US rates, thanks to Philippines' stable current account surplus and robust domestic growth outlook.

Peg breaks
A currency peg is a type of exchange rate regime in which a currency's value is fixed against the value of another single currency, to a basket of other currencies, or to another measure of value, such as gold. A peg breaks when such currency is no longer fixed to the chosen benchmark.

2015 was notable for a number of currency pegs, caps, and floors that fell through, including in Switzerland, China, Kazakhstan, and Vietnam.

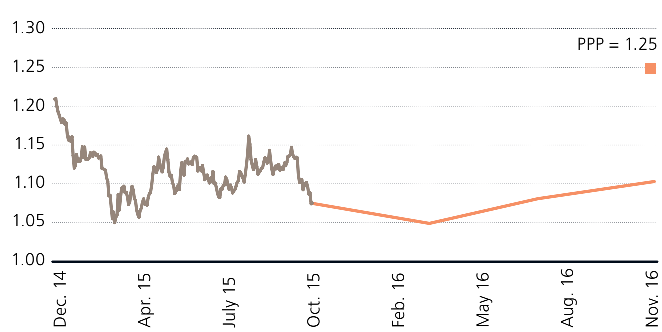
Prior to a peg break, volatility is low, meaning it is often "cheap" to invest in the potential of a peg break. In the event of a peg break, volatility and returns can be outsized. That said, investors should be cautioned that "timing is everything" and premium spent or carry paid betting upon a peg will be lost if the peg is maintained.

Options in both the Hong Kong dollar and the Saudi Arabian riyal have recently indicated an elevated probability of their pegs breaking, although we still deem both events as unlikely in the year ahead.

Fig. 22

More downside for EUR, but reaching a floor

EURUSD including forecasts and purchasing power parity estimates



Source: Bloomberg, UBS, as of November 13, 2015

Commodities

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We expect commodity prices to stabilize in 2016, with an overall upward move in the high single digits. Crude oil will likely drive most of the improvement, although an ongoing economic deceleration in China should keep base metals weak. We expect the outlook for gold to improve next year as US real interest rates sink deeper into negative territory.

Oil – a more positive year
After signs of bottoming in 1H 2015, oil prices have suffered again in the second half of the year, amid concerns of continued oversupply and Chinese demand leveling off. At the time of writing, Brent crude is down by more than 20% year-to-date.

We expect oil prices to stabilize and partially recover in 2016, and forecast USD 63/bbl (Brent) and USD 60/bbl (WTI) in 12 months' time.

Low prices have curbed capital spending around the world, in particular in US shale wells. As a result, we expect oil production outside of OPEC to contract by at least 0.3 million barrels per day (mbpd) in 2016.

Meanwhile, oil demand growth should stay robust as drivers change habits in response to cheap fuel – driving more and buying energy-consumptive vehicles. We expect oil consumption to rise by 1.1–1.2 mbpd in 2016. This should almost clear the current market surplus by 2H 2016.

Gold – reaching a floor
After a strong start to the year, buoyed by a new quantitative easing policy announced by the European Central Bank, gold prices then ebbed lower through 2015. Prices are down 8.6% year-to-date at the time of writing, marking the third year of decline in a row.

Looking ahead, while the Federal Reserve is likely to raise interest rates, we believe inflation is likely to increase more quickly (from 0.2% to 1.6% in the US, for instance), boosting the relative appeal of gold as we go through the year. Added support could come from emerging market central banks.

That said, with few signs of inflation rising rapidly, and a lack of momentum to support ETF buying, there is little reason to expect significant upside, either. We expect relatively flat prices in 2016: our 12-month target stands at USD 1,100 an ounce.

Industrial metals – under pressure
Industrial metals suffered again in 2015, due to weaker-than-expected demand from China. Now 50% below their 2011 peak, prices are in line with 2008 lows. Most industrial metals are trading into their cost of supply.

However, we expect only marginally higher prices in 2016. Supply cuts are still needed to balance the market. Demand growth from China will probably remain sluggish. Copper and iron ore are most at risk.

Agricultural commodities – little excitement
Agricultural commodity prices fell in 2015 for the third year running, with the Bloomberg Index down 11% year-to-date. The sharp rally in the drought summer of 2012 seems distant; prices are down 50% since.

We believe the worst of the decline is over, and expect prices to stabilize in 2016, and returns to average 2–3%. El Nińo-related climate disruptions could increase prices for palm oil. In contrast, soybeans may post another surplus. Production in Brazil is heading for a record above 100 million tons, and stocks are huge.

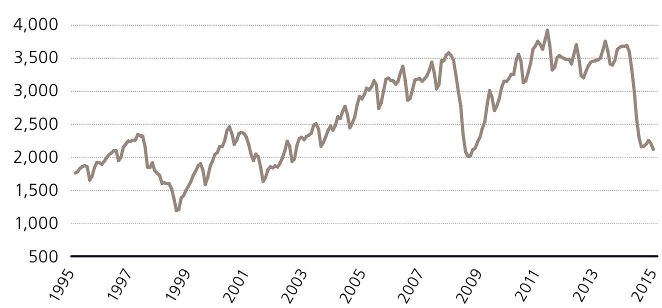
Commodity	Unit	Price	12m forecast	Price return (%) 2014	Price return (%) 2015 ytd
Brent crude oil	USD/bbl	43.6	63	-48.3	-23.9
WTI crude oil	USD/bbl	40.3	60	-45.9	-24.4
Gold	USD/oz	1086	1100	-0.4	-8.6
Platinum	USD/oz	861	1000	-11.8	-29.1
Silver	USD/oz	14.3	14	-17.5	-9.1
Copper	USD/mt	4706	4750	-16.8	-25.2
Iron ore	USD/mt	46	45	-47.1	-35.0
Corn	USD/bu	3.67	4.2	-5.9	-9.4
Wheat	USD/bu	4.95	5.2	-2.6	-16.3
Soybeans	USD/bu	8.55	8.2	-22.3	-16.2
Cocoa	USD/mt	3369	2800	+7.4	+15.8
Palm oil	MYR/MT	2300	2600	-12.8	-6.9

Note: 12-month forecast as of November 24, 2015
Source: UBS, as of November 17, 2015

Fig. 23

Lower supply to help oil stabilize in 2016

Baker Hughes total world oil & gas rotary rig count



Source: Bloomberg, UBS, as of November 13, 2015

Real estate

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Much has changed since the financial crisis, but on average, real estate prices are now higher than pre-crisis peaks. Some housing booms stand out. London and Hong Kong face the highest risk of correction. Zurich and Geneva seem only modestly overvalued, while New York looks fairly priced.

The UBS Global Real Estate Bubble Index

The UBS Global Real Estate Bubble Index combines measures of house price valuations with indicators of market activity, and compares them against the long-term norms for individual cities.

The price-to-income component measures how many years' gross income would be needed to pay for a centrally located 60m² dwelling. In London, this is 14 years, while in Frankfurt it is just five.

The price-to-rent ratio measures the expense of buying a flat compared to the cost of renting it. This ranges from over 30 years for Zurich, Vancouver, Hong Kong and Geneva, down to 20 years or below for Amsterdam, San Francisco, Boston and Chicago.

The index also includes measures to detect market momentum – including the change in the outstanding mortgage credit to GDP and the change in the construction share of GDP.

Finally, we measure the prices of city properties compared to the rest of the country – which can indicate if a metropolis is decoupling from its surrounding areas.

London and Hong Kong appear most overvalued

Hong Kong's record-high price-to-income ratio of 21, and a price-to-rent ratio of 33 indicate a high risk of correction. Fueled by a credit boom, Hong Kong's residential market performed comparatively well during and after the financial crisis. Without any long-term correction, property prices are now 60% higher than in 2006, and almost 200% higher than in 2003. Rents, in contrast, have grown by only 35% in real terms.

London looks even more exposed, with the highest bubble index score in the world. In real terms, London house prices are 6% above their 2007 peak, despite nationwide prices having declined by 18%. The decoupling of the London real estate market from the rest of the UK is even more drastic considering that in the same period, real average earnings fell by 7% both in London and UK-wide.

Zurich, Geneva, and New York not in bubble territory

Zurich's index score indicates a moderate degree of overvaluation. In the last five years, prices have climbed 25%, while rents and incomes stagnated. But, in line with the broader Swiss housing market, prices have increased more recently at a slower rate. House prices in Geneva have fallen by 5% in the last three years as countrywide prices rose.

New York's residential market scores indicate fair valuation. Real house prices in New York bottomed in 2012 after a severe five-year correction following the subprime crisis. Despite the recent rebound, the price for an average house in inflation-adjusted terms is currently still more than 25% below its 2006 peak. Both price-to-income and price-to-rent ratios reverted to their historical averages.

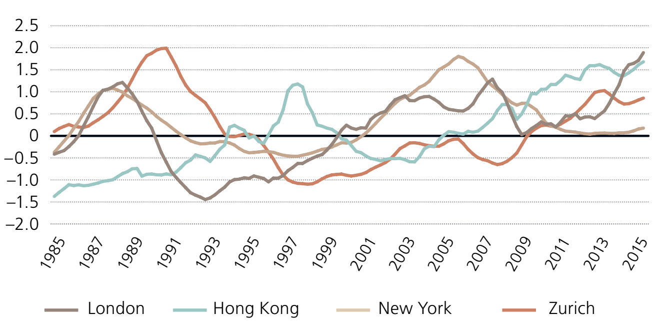
Bubble risk	Overvalued	Fair-valued	Undervalued
London	Sydney	New York	Chicago
Hong Kong	Vancouver	Boston	
	San Francisco		
	Amsterdam		
	Geneva		
	Zurich		
	Paris		
	Frankfurt		
	Tokyo		
	Singapore		

Source: UBS, as of November 13, 2015

Fig. 24

Some look bubblier than others

UBS Global Real Estate Bubble Index



Source: UBS, as of November 13, 2015

Appendix

Sources of strategic asset allocations and investor risk profiles
Strategic asset allocations represent the longer-term allocation of assets that is deemed suitable for a particular investor. The strategic asset allocation models discussed in this publication, and the capital market assumptions used for the strategic asset allocations, were developed and approved by the WMA AAC.

The strategic asset allocations are provided for illustrative purposes only and were designed by the WMA AAC for hypothetical US investors with a total return objective under five different Investor Risk Profiles ranging from conservative to aggressive. In general, strategic asset allocations will differ among investors according to their individual circumstances, risk tolerance, return objectives and time horizon. Therefore, the strategic asset allocations in this publication may not be suitable for all investors or investment goals and should not be used as the sole basis of any investment decision. Minimum net worth requirements may apply to allocations to non-traditional assets. As always, please consult your UBS Financial Advisor to see how these weightings should be applied or modified according to your individual profile and investment goals.

The process by which the strategic asset allocations were derived is described in detail in the publication entitled "UBS WMA's Capital Markets Model: Explained, Part II: Methodology," published on 22 January 2013. Your Financial Advisor can provide you with a copy.

Deviations from strategic asset allocation or benchmark allocation
The recommended tactical deviations from the strategic asset allocation or benchmark allocation are provided by the Global Investment Committee and the Investment Strategy Group within CIO Wealth Management Research Americas. They reflect the short- to medium-term assessment of market opportunities and risks in the respective asset classes and market segments. Positive/zero/negative tactical deviations correspond to an overweight/neutral/underweight stance for each respective asset class and market segment relative to their strategic allocation. The current allocation is the sum of the strategic asset allocation and the tactical deviation.

Note that the regional allocations on the Equities and Bonds pages in *UBS House View* are provided on an unhedged basis (i.e., it is assumed that investors carry the underlying currency risk of such investments) unless otherwise stated. Thus, the deviations from the strategic asset allocation reflect the views of the underlying equity and bond markets in combination with the assessment of the associated currencies. Thus, the deviations from the strategic asset allocation reflect the views of the underlying equity and bond markets in combination with the assessment of the associated currencies. The detailed asset allocation tables integrate the country preferences within each asset class with the asset class preferences in *UBS House View*.

Scale for tactical deviation charts

Symbol	Description/Definition	Symbol	Description/Definition	Symbol	Description/Definition
+	moderate overweight vs. benchmark	–	moderate underweight vs. benchmark	n	neutral, i.e., on benchmark
++	overweight vs. benchmark	– –	underweight vs. benchmark	n/a	not applicable
+++	strong overweight vs. benchmark	– – –	strong underweight vs. benchmark		

Source: UBS

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Appendix

Emerging Market Investments

Investors should be aware that Emerging Market assets are subject to, among others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and sociopolitical risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. WMR generally recommends only those securities it believes have been registered under Federal US registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as "Blue Sky" laws). Prospective investors should be aware that to the extent permitted under US law, WMR may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.

For more background on emerging markets generally, see the WMR Education Notes "Investing in Emerging Markets (Part 1): Equities," 27 August 2007, "Emerging Market Bonds: Understanding Emerging Market Bonds," 12 August 2009 and "Emerging Markets Bonds: Understanding Sovereign Risk," 17 December 2009.

Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment-grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Subinvestment-grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher-yielding bonds for shorter periods only.

Nontraditional Assets

Nontraditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments; there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund, and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- **Hedge Fund Risk**: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-US securities and illiquid investments.
- **Managed Futures**: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- **Real Estate**: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- **Private Equity**: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- **Foreign Exchange/Currency Risk**: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in US dollars, changes in the exchange rate between the US dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a US investor.

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