Year Ahead 2019

UBS House View

Global
Chief Investment Office GWM
Investment Research

Turning points

Foreword

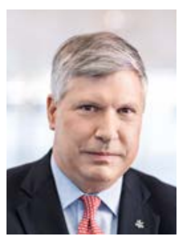
Welcome to *Year Ahead 2019*, our outlook on the year to come.

We've entered a more challenging investment environment. Geopolitical uncertainty, tighter monetary policy, and a maturing global cycle are contributing to more turbulent markets. As we detail in the pages that follow, there are still attractive opportunities around the globe. Yet as the economic cycle advances, investors will need to be ready for ongoing volatility.

As markets grow more uncertain, ensuring you have a disciplined plan in place to meet your financial goals becomes more crucial. Our approach to wealth management based on Liquidity. Longevity. Legacy.* – or what we call UBS Wealth Way – can help investors plan for their long-term goals, while helping reduce the risk of rash decisions being made in choppy markets. We believe this framework will continue to serve our clients well as the cycle matures.

We wish you the best for 2019 and remain by your side to help you achieve your financial goals.

Martin Blessing



Tom Naratil

* Timeframes may vary. Strategies are subject to individual client goals, objectives, and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

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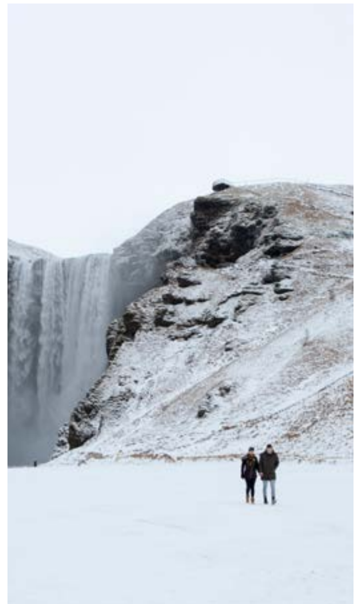


Liquidity. Longevity. Legacy.

A clear plan gives you the best chance of meeting your long-term objectives.

To find out more about the Year Ahead 2019, visit ubs.com/cioyearahead

Turning points

As I write this, in late November 2018, our view is that, on balance, overweight equity exposure, combined with relative value trades, and portfolio hedges, is the right positioning for the start of 2019. As we detail in the pages that follow, we expect continued volatility: economic growth is slowing, central banks are tightening policy, and political risks all pose challenges, making hedging prudent. But typical indicators around consumption, investment, and employment are not warning of recession. Inflation remains low enough for tightening to proceed gradually, and many assets have already moved to price in a more uncertain outlook.

Mark Haefele
Chief Investment Officer
Global Wealth Management

Lake Ontario. JP Danko, Stocksy

In the weeks and months to come, we face key turning points in the big themes that will drive markets in the year ahead. At the time of writing, two in particular stand out for their near-term importance and potential symbolism:

Political choices
We are at an important turning point for how investors think about political risk.

Since its inauguration, many of the Trump administration's policies have been pro-growth. Yet, with the negative effects of its trade policy starting to show in the economic data, the administration faces a choice between supporting growth and pursuing its strategic goals, including in its rivalry with China.

A sustained improvement in relations with China would help alleviate market concerns and help support higher asset prices. However if, having observed the negative impact of already implemented tariffs, the US administration still chooses to conflict with China, it would show that near-term economic considerations are no longer paramount in its policy agenda. Should this prove to be the case, investors would be right to demand higher risk premia.

Central bank choices
Another key turning point is how central banks respond to the increase in market volatility, economic uncertainty, and evolving trade policy.

Market-implied inflation expectations are falling alongside oil prices, credit spreads are widening, and uncertainty about the effect of higher rates on the US housing market is rising. While all of these points need to be put in the context of a still strong US jobs market, the Fed now has an opportunity to signal greater flexibility around its interest rate path, which would likely be well received by markets.

But if the Fed doesn't signal flexibility, it could be a significant indicator that it risks overtightening policy in 2019. The result would be that global markets grow increasingly sensitive to downside economic or corporate surprises.

Preparing for the year ahead
As we prepare for the year ahead, I hope our scenario analysis (see page 18) can serve as a guide for the potential magnitude of the events we face. Throughout the weeks and months to come, we will endeavor to keep you updated on both what we think and how we think, as we navigate portfolios through 2019's turning points.

Navigating 2019

The investment environment is becoming more challenging as the global economic cycle matures. With economic growth, global politics, and central bank stimulus all at turning points, volatility has increased and drawdowns are becoming more commonplace. Investors should expect more of the same in 2019, as markets begin to try and anticipate an end to the cycle.

With the right strategies in place, we believe this is navigable. We don't currently see the conditions commonly associated with an impending recession, and there are still growth opportunities and pockets of value. Prospering in this environment will require selectivity, diversification, and a clear financial plan, but with them in place, opportunities are still out there.

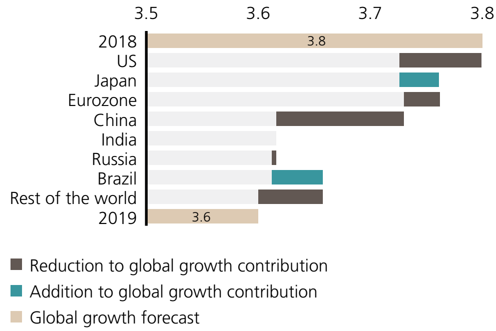
A challenging backdrop

Slower growth. After 3.8% in 2018, we expect global economic growth to slow to 3.6% in 2019 (see Fig. 1.1). Our outlook is that US growth will be constrained by ebbing fiscal stimulus and higher interest rates. In the Eurozone, solid domestic demand will not be sufficient to offset reduced export growth. China, meanwhile, faces the twin pressures of US tariffs and economic rebalancing. The decline in global growth will mean a weaker tailwind for global markets, which could begin to anticipate an end of the economic cycle as 2019 progresses.

Fig. 1.1

Global growth is expected to slow

Contribution to economic growth from select countries and regions, in %



Source: UBS, as of 20 November 2018

Tighter monetary policy. The coming year will represent the first time since the global financial crisis when central bank balance sheets are on track to end the year smaller than they were at the start of it (see Fig. 1.2). We expect US rates to end the year 100bps higher than today, and for the European Central Bank to have ended quantitative easing by the time 2019 begins. Low and falling unemployment rates also increase the risk of higher inflation, which could spark even faster rate rises. Tighter monetary policy will focus market attention on debt serviceability. Potential hotspots include US and Chinese corporate leverage and Italian government debt.

Weaker overall earnings growth. We see profit growth in the US market, which comprises more than half of the global equity market, falling off to roughly 4% in 2019 from an eight-year high of 21% in 2018. The one-off boost from corporate tax cuts will not be repeated, and tariffs will begin to have a negative impact. We anticipate 9% earnings growth in emerging markets and around 5% in the Eurozone.

Political challenges. The world faces key political turning points. US-China tensions run deeper than disagreements about trade: the US National Security Strategy labels China "a revisionist power…shaping a world antithetical to US values and interests," and so economic considerations may be given less priority in future policy setting. As such, investors should prepare for relations between the two powers to continue affecting markets. Meanwhile, elections of note include those in India, South Africa, Greece, Canada, and Argentina. Europe will also vote for the EU parliament, US presidential campaigning will begin, while instability could provoke a return to the polls for citizens in Italy, Germany, and the UK. Polarized electorates make political outcomes even more uncertain than normal.

Lake Ontario. JP Danko, Stocksy

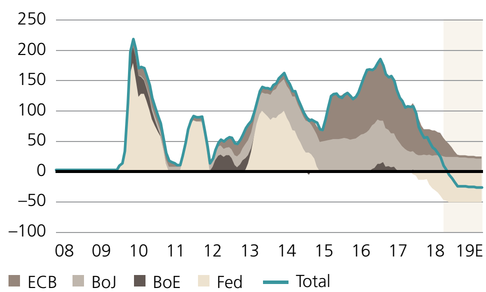
Environmental credit crunch. The world continues to use resources in an unsustainable way, which is becoming an issue for financial markets as much as for the environment and society. Social media means corporate behavior is more closely scrutinized than ever, and companies have come to appreciate that consumers can vote with their wallets. Corporate valuations are now increasingly tied to intangible assets, brand reputation, and environmental and social performance, which are inherently more vulnerable than hard assets.

Limited long-term return potential. After a decade in which stock market returns have vastly outperformed economic growth and central banks have provided unprecedented support for bonds, investors will have to temper their expectations in the coming years.

Fig. 1.2

Central banks are reducing their balance sheets in aggregate

in USD billion



E = Estimate

Source: Haver Analytics, UBS, as of 7 November 2018
Note: Includes securities purchases of the ECB, Federal Reserve, Bank of England and Bank of Japan (financed by central bank money creation). 3-month moving average until end of 2019.

But the environment is navigable

All that said, we consider it possible to steer through the hazards posed by the changing environment.

A recession looks unlikely. Current rates of consumption, investment, and employment growth are not historically consistent with an impending recession, and we think the typical causes of a downturn look unlikely to materialize in 2019 (see Fig. 1.3). Our base case is for inflation to stay contained, allowing central bankers to remain sensitive to growth. We don't foresee a major fiscal policy shift or a commodity price shock. Consumer balance sheets are in solid shape and improvements in banking sector capitalization since the financial crisis reduce the risk of a global credit crunch.

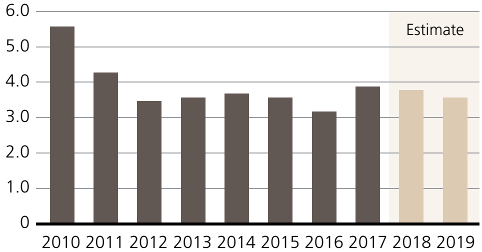
There are growth opportunities and pockets of value. Economic and earnings growth are waning in aggregate. But this slowdown will not be felt uniformly by every country, sector, or company. We expect robust growth in firms exposed to secular trends like population growth, aging, and urbanization. Meanwhile, some assets have already begun to factor in a more challenging backdrop.

Most political risks will prove idiosyncratic. Individual issues, including but not limited to Brexit, North Korea, the Eurozone, and the Middle East, will inevitably surface at some point in the coming year. While some risks, like a global trade war, require close monitoring, concerns about individual countries usually don't upset global markets as a whole. We also shouldn't discount the possi-

Fig. 1.3

We don't expect a recession

Real global GDP growth since 2010, in %



Source: UBS, as of 20 November 2018

Lake Ontario. JP Danko, Stocksy

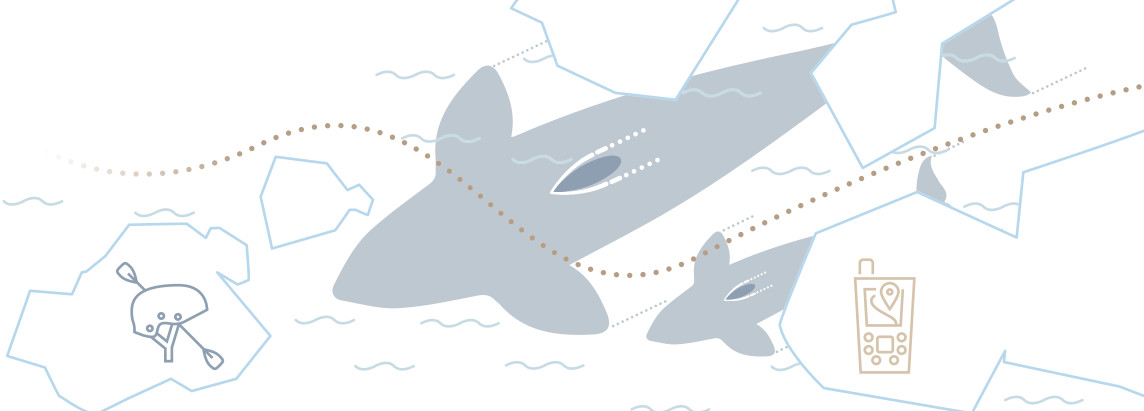
bility of positive developments, like a sustained reduction in trade tensions, even if such a scenario is unlikely (see page 18).

Sustainability solutions for investors. Investors can play a role in reducing sustainability challenges while earning returns commensurate with equivalent traditional investments. For example, investors could take advantage of the fact that a wealthier world is willing to spend more on ecological goods such as better air quality for its children. There is now ample evidence that sustainable investing does not hurt your portfolio.

Planning can help reduce uncertainty. Building a clear financial plan can assist investors in dealing with heightened uncertainty and limited long-term return potential, and is particularly valuable as the bull market ages. Understanding the implications of volatility for your portfolio and goals can help you avoid making rash and costly decisions.

Strategies for a maturing cycle

The 2019 investment backdrop is challenging, but with the right measures, we believe investors can prosper.

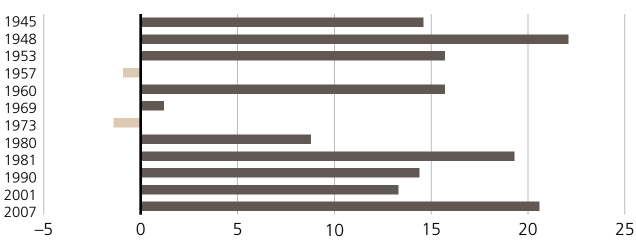


Stay invested. Growth is slowing, but we do not expect a recession. We think that staying invested will pay off (see Fig. 1.4), although investors should prepare for greater volatility as the market may begin to anticipate an end to the cycle.

Fig. 1.4

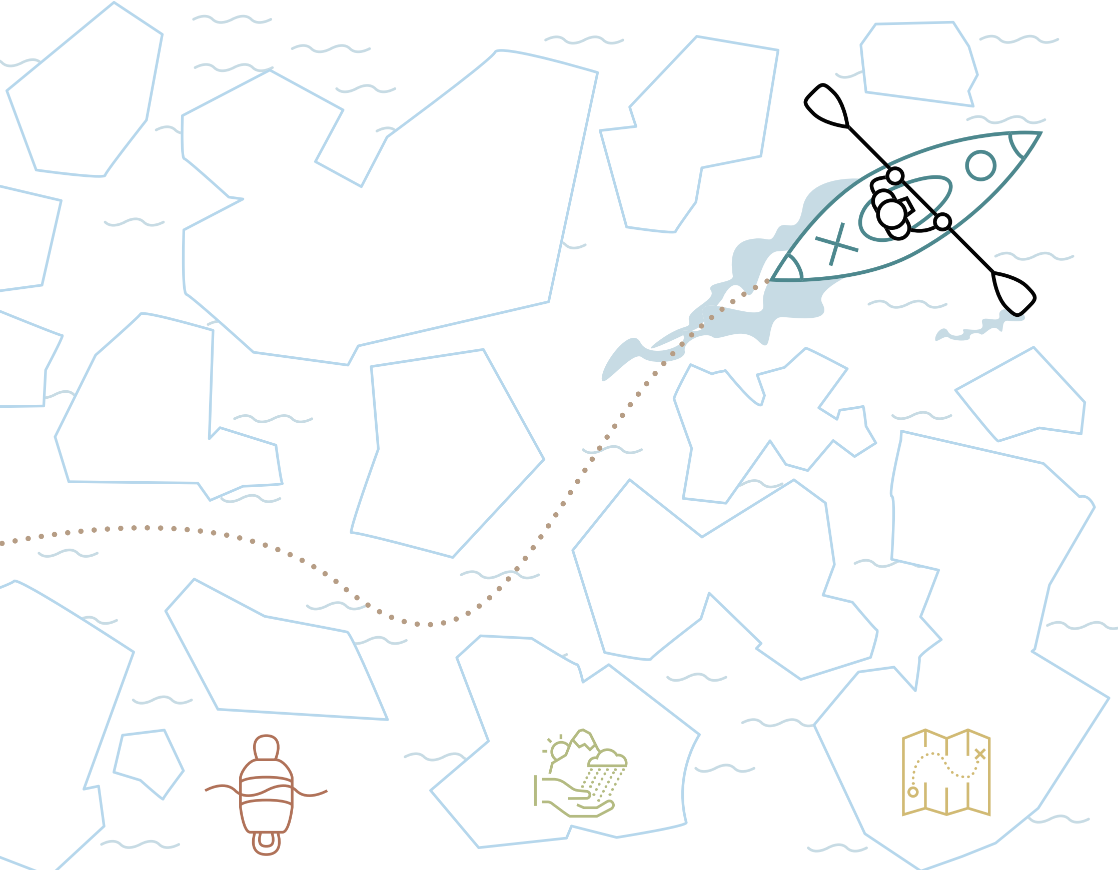
Equities historically grinded higher before a recession

US stock total returns 18-6 months before a recession, in %



Source: Bloomberg, Ibbotson, NBER, UBS, as of 6 November 2018

Be selective. Amid fading earnings growth investors should focus on companies exposed to secular growth trends, those already pricing in adverse scenarios, or those with a track record of weathering downturns.



Diversify. Political and individual corporate risks will inevitably surface. Most, however, will prove idiosyncratic to individual countries and sectors, and can be avoided through diversification across a broad range of market drivers.

Go sustainable. Investors can play an important role in solving sustainability challenges by deploying capital in a responsible way while aiming to match or even improve on potential returns available in equivalent traditional investments.

Plan. Now is a good time to build a clear financial plan. The Liquidity. Longevity. Legacy. (3L)* approach, that we developed (see page 60), enables investors to maintain a liquidity buffer to protect spending amid market volatility, while ensuring portfolios remain on track to achieve longer-term goals.

* Timeframes may vary. Strategies are subject to individual client goals, objectives, and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

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Surprises for 2019?

Key investment risks

Selected Scenarios	Scenario Description	Expected 6m market performance for select asset classes
Base case		
Positive outlook with increased volatility	Global economic growth slows but remains solid, while ongoing trade tensions, monetary tightening, and uncertainty about growth keep volatility high.	↑ **US equities** +0%–5% due to solid economic activity supported by consumer and business confidence and capital access ↑ **Eurozone equities** +0%–5% amid political uncertainty surrounding Italy, Brexit, and the ongoing trade conflict ↑ **EURUSD** between 1.15 and 1.20 as monetary policy normalizes
Key downside scenarios		
Trade: Further US sanctions	US-China trade disputes induce a slowdown in China, considerable uncertainty, and a rerouting of global trade. More countries start to feel pain via disrupted supply chains.	↓ **US equities** down 5%–10% composed of a 5% hit to our EPS estimates coupled with P/Es contracting 0%–5% ↓ **Chinese equities** down 20%–25% as sentiment falls further with negative economic consequences ↑ **USD** appreciates to around EURUSD 1.10 as US tariffs support the USD
Fed ends the business cycle sooner	As US inflation rises rapidly, the Fed is forced to hike rates at each FOMC meeting. This leads to a flat or inverted US Treasury yield curve by mid-2019, and an equity market sell-off. A US recession starts in early 2020.	↓ **US equities** down 10%–15% as valuations fall 5–10% as fears about the end of the cycle rise, and earnings do not grow in 2019 ↓ **US high yield** down 6%–9% as spreads widen toward recession levels, while mid- to longer-term US Treasury yields fall ↑ **USD** appreciates, bringing EURUSD to or below 1.10 as the USD strengthens due to contractionary monetary policy

Selected Scenarios	Scenario Description		Expected 6m market performance for select asset classes
Key upside scenarios			
Trade: Negotiations avert additional sanctions	Negotiations between the US and China result in actual progress and a reduction of trade barriers. Although tensions remain high, both countries agree on a trade truce.	↑	**US equities** +10%–15% as increased confidence in the cycle allows P/Es to expand to 17.5–18x and 2019 EPS estimates for the S&P 500 hold in the mid-USD 170s
		↑	**Chinese equities** +10%–15% due to a strong recovery on risk sentiment and better-than-expected fundamentals
		↓	**USD** depreciates to EURUSD 1.20–1.25
China: Stable GDP growth	Chinese GDP growth returns to a 6.6%–6.8% range, and the current account balance goes back above USD 100bn.	↑	**Chinese equities** +15%–20% due to a valuation recovery as growth beats consensus expectations
		↑	**EM bonds (EMBIGD)** return 6%–7% as spreads tighten to around 310bps due to improving EM growth prospects
		↑	**CNY** appreciates to USDCNY 6.50 as better-than-expected Chinese growth supports the domestic equity market, preventing outflows and supporting inflows of capital

Expected total returns over a 6-month horizon

Note: Upside and downside scenarios are possible events outside of CIO's base case expectations. This list is not exhaustive. We are closely monitoring developments in the UK, Italy, and the Middle East among others.

Expected trend in asset class

↓ ↓ ↓ ↑ ↑ ↑

–50% 0% +50%

Source: UBS, as of 8 November 2018

Svalbard, Norway. Chris Zielecki, Stocksy

Orienting for the next bear market

We don't currently see the conditions normally associated with an impending bear market. But investor concerns about how much upside is left in this bull market (see page 25) is directing attention toward how the next bear market might look.

Expectations for how and when events might materialize are often set by recent experience. The two most recent bear markets (in the US at least) were much worse than average (see Table 1), so these memories may have left investors prone to overestimating the scale of any coming drawdown.

In our view, the next bear market will likely resemble earlier, less severe ones. The size of recessions and bear markets are largely defined by excesses that built up during the boom years. And in comparison to the extreme equity valuations of 2000 leading to the dot.com bust, or the financial sector leverage that prevailed in 2007, the excesses this time appear more contained.

We believe that the next equity bear market – when it occurs – is likelier to be an average bear, with a 25%–30% drop for global equities from the market peak.

Table 1

Diversified portfolios can protect against the most painful parts of equity bear markets

Comparative statistics for equity bear markets since World War II

Peak year	1946	1961	1968	1972	1987	2000	2007	Average
US large-cap stocks								
Length of prior bull market*	169	184	78	31	157	155	62	119
Time between market cycles**	204	190	84	50	179	158	87	136
Peak	Mar 1946	Dec 1961	Nov 1968	Dec 1972	Aug 1987	Aug 2000	Oct 2007	
Trough	Nov 1946	Jun 1962	Jun 1970	Sep 1974	Nov 1987	Sep 2002	Feb 2009	
Recovery date	Oct 1949	Apr 1963	Mar 1971	Jun 1976	May 1989	Oct 2006	Mar 2012	
Max drawdown	–21.8%	–22.3%	–29.4%	–42.6%	–29.6%	–44.7%	–51.0%	–34.5%
Time to full recovery (new all-time high)***	41	16	28	42	21	74	53	39
Drawdown time***	6	6	19	21	3	25	16	14
Recovery time***	35	10	9	21	18	49	37	26
Months of prior gains "erased"	15	36	66	118	18	64	141	65
60/40 stock/bond portfolio								
Peak	May 1946	Dec 1961	Nov 1968	Dec 1972	Aug 1987	Aug 2000	Oct 2007	
Trough	Nov 1946	Jun 1962	Jun 1970	Sep 1974	Nov 1987	Sep 2002	Feb 2009	
Recovery date	Oct 1948	Mar 1963	Dec 1970	Jan 1976	Jan 1989	Oct 2004	Dec 2010	
Max drawdown	–13.4%	–13.0%	–17.6%	–26.4%	–17.4%	–21.7%	–29.9%	–19.9%
Time to full recovery (new all-time high)***	29	15	25	37	17	50	38	30
Drawdown time***	6	6	19	21	3	25	16	14
Recovery time***	23	9	6	16	14	25	22	16
Months of prior gains "erased"	14	17	19	25	5	35	21	20

* Months from previous trough to this cycle peak
** Months between previous peak and this cycle peak
*** Months

Source: Morningstar Direct, R: PerformanceAnalytics, UBS as of 18 October 2018

Top ideas

By staying invested but being selective, diversified, investing sustainably, and building a clear financial plan, we believe investors can navigate the challenges of 2019. Here are our top ideas summarized below.

Victor Benard, Unsplash

Our view

Growth will slow and monetary policy will tighten, but a recession in 2019 looks unlikely.

Your action

Stay invested but prepare portfolios for volatility.

Recommendations

Global equities	26
Avoid excessive credit risk	39
US Treasuries	40
Euro synthetic credit exposure	40
Japanese yen	48
Hedge currency exposure	49

Our view

Earnings growth will be slower in 2019 than in 2018.

Your action

Be selective. Select investments exposed to secular growth, high-quality earnings, or those pricing overly-negative scenarios.

Recommendations

Global quality	26
US and China financial, global energy	26
US and EM value	28, 32
China; Brazil; South Korea; Vietnam	32, 33
Longer-Term Investments	36
Asia high yield, Asia IG	43

Our view

Politics, ranging from US-China trade negotiations to the Italian budget and Brexit, will affect markets.

Your action

Diversify investments across countries, sectors, and market drivers.

Recommendations

Our view

Companies will continue to fall short of sustainability expectations, and investors and regulators alike will demand improved ESG standards.

Your action

Invest sustainably to help solve the world's major challenges and benefit from growth and innovation in the market, earning returns commensurate to traditional investments.

Recommendations

Our view

Longer-term returns will be more limited than in previous years.

Your action

Plan. Ensure sufficient allocation to markets with decent long-term prospects, and develop a clear financial plan to achieve financial goals.

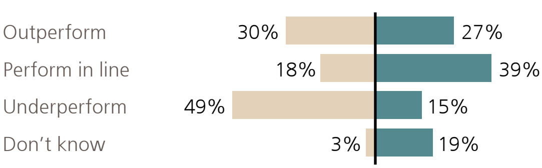
Recommendations

The wisdom of crowds

Professional investors **Individual investors**

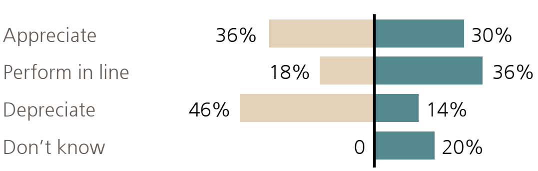
In our investment process, we seek to test our ideas against the views of other top professionals. We also aim to stay in touch with the perceptions of individual investors. Our surveys* reveal a gap in expectations between these groups for 2019 and beyond.

Will the US market outperform or underperform international equities in 2019?



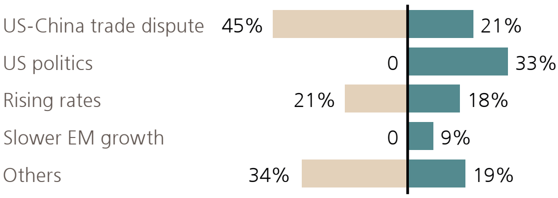
While two-thirds of individual US investors expect US stocks to either match or beat global markets in the coming year, professionals are more skeptical: close to half of them see the US lagging.

Will the US dollar appreciate or depreciate against the euro in 2019?



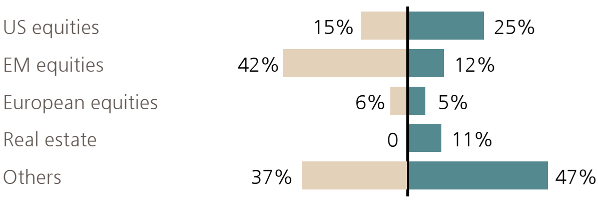
On the US dollar, nearly half of managers share our view that it will decline versus the euro. Less than one-sixth of individual US investors agree.

What do you perceive as the greatest risk to investors in 2019?



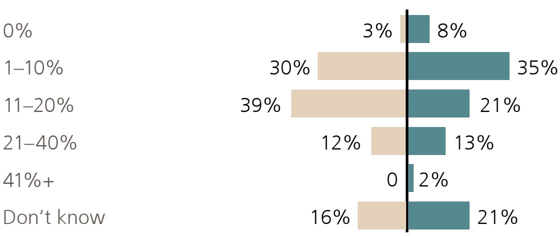
Individual US investors are focused on US political risks. But few professional investors regard them as the primary threat. Instead, they see US-China trade tensions and higher rates as the greater risks.

Where do you see the greatest investment opportunity in 2019?



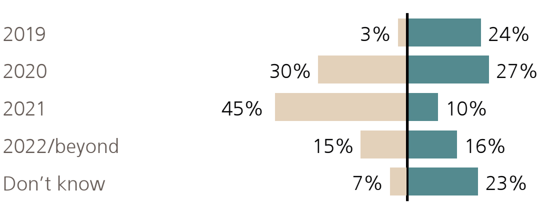
The most popular asset class for individual US investors entering the new year is US equities. For managers the top pick is emerging market stocks, but they also highlighted diverse themes such as emerging market debt and commodities.

How much upside in % do you think the US equity market has before the next bear market? (A bear market is when equity prices fall more than 20% from their previous high.)



Professional investors are more optimistic than individual US investors on how much upside remains in the US equity market.

When do you expect the next recession to start?
By recession, we mean two consecutive quarters with a decline in US GDP.



Half of the individual US investors surveyed expect the next recession to start within two years. The most common answer among professionals was 2021.

*We asked 502 HNW investors with at least USD 1M in investable assets as part of our Pulse survey, from October 26–29 2018, as well as professional investors who contribute to our UBS Investor Forum and Research Advisory Board.

Equities

Oslo, Norway. Ole Jørgen Bakken, Unsplash

Equity investors should brace for volatility but stay invested. Politics, monetary policy, and incoming economic data will all contribute to higher volatility, but we don't expect a recession, see valuations at a discount to historical averages, and note returns in the latter part of the cycle are often good. Look for value to outperform growth in the US and emerging markets, and consider neglected sectors like US financials and global energy.

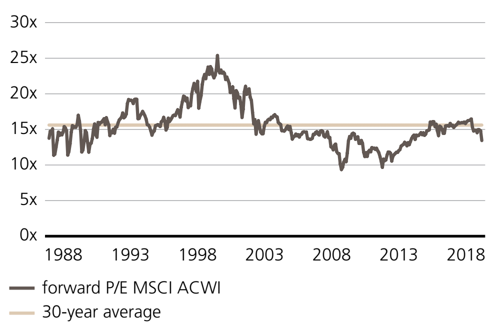
Late-cycle return potential. We do not expect a recession in 2019 and see global GDP expanding at 3.6%, with a mid-single digit rate of earnings growth. US stocks have returned 12% on average in the year leading up to the six months before the onset of a recession, based on data going back to 1945 (see Fig. 1.4), but monetary policy, politics, and incoming data will all play a role in shaping the outlook.

Favorable valuations. The 12-month forward price-to-earnings ratio of around 14x for global equities represents a 10% discount to the three-decade average (see Fig. 3.1). The equity risk premium, which gauges the attractiveness of stocks versus bonds, is around 6% versus an average since 1991 of 3.4%.

Fig. 3.1

Valuations are attractive relative to historical averages

MSCI All Country World Index 12-month forward P/E and its 30-year average



Source: Thomson Reuters, UBS, as of 7 November 2018

Prepare for volatility. Volatility increases in the latter stages of the economic cycle. Since 1990, the VIX index has averaged 22 in the six months prior to the start of US recessions, versus 18 during other periods in which the economy is expanding.

Our main messages for equity investors in 2019 are:

- **Diversify globally.** No single region offers a uniquely compelling case. The US economy remains strong, but with a price-to-earnings ratio of around 17x, valuations are 15% higher than the global average. Eurozone and emerging market (EM) stocks have lower valuations, but both regions are more exposed to China's slowdown. We favor global diversification within equity holdings, which should also help mitigate volatility.

- **Look for value and quality.** We expect US and EM value to outperform growth, reversing their 2018 underperformance. "Quality" companies, meanwhile, with higher profitability, lower financial leverage, and less earnings variability than average, should withstand volatility better than the overall market.

- **Consider neglected sectors.** Financials could be set to outperform in the US and China, thanks to rate rises and favorable changes in regulations in the former, and to economic stimulus in the latter. The US and European energy sectors also offer value. And we think oil prices will recover in early 2019 (see page 51).

Long-term outlook

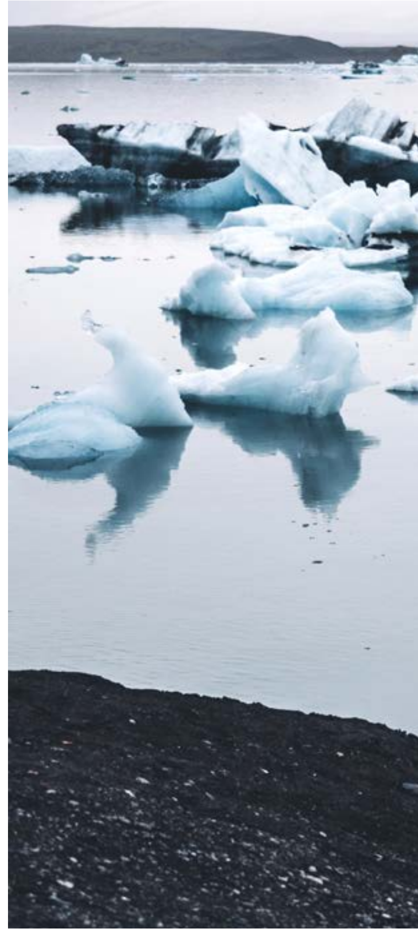
Returns in the coming decade will be lower than in the past decade. Higher interest rates and relative labor scarcity will pressure margins. The tech growth spurt will moderate. Share buybacks will become more expensive to finance.

Within our long-term outlook, several themes stand out:

- **US-focused investors should diversify.** US stocks have outpaced global equities by around 50 percentage points over the past seven years, returning a total of about 150% versus 100%. Over the next seven years, we expect higher long-term returns outside the US. US stocks trade in line with their average trailing price-to-earnings (P/E) ratio over the past 30 years, while the global index is at a 20% discount.

- **Emerging markets for the long term.** EM stocks face short-term headwinds, such as a strong US dollar and rising US interest rates. For more far-sighted investors, however, valuations are appealing, with a trailing P/E c.25% below the 30-year average.

- **Japanese stocks have a good long-term outlook.** Japan is putting its history as a market suffering from weak inflation and poor corporate governance behind it. Still, the index is valued at just 12x trailing earnings – a 15% discount to global equities. Investors could benefit even more by holding unhedged positions in the market (see page 48).



US equities

With the bull market aging, investors will inevitably start to anticipate an end to the economic cycle. However, we do not expect a recession in 2019 and see some segments of the market as oversold. We have a moderate bias for cyclicals over defensives and value over growth, and also like the financial and energy sectors.

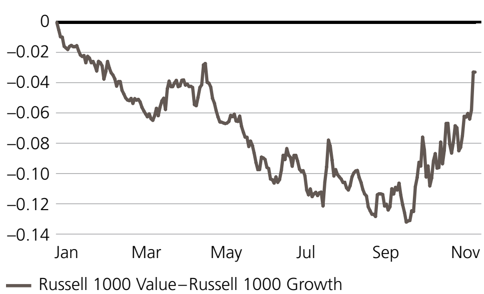
– **Favor financials and energy.** Financials' valuations are near a 10-year low relative to the market and do not reflect solid economic growth, rising rates, deregulation, and high capital returns. The sector's total yield (including dividends and share buybacks) of more than 6% is the highest of any sector. Energy stocks, meanwhile, have lagged in recent months due to falling oil prices. But we have a positive outlook on oil in the first half of 2019 (see page 51), and relative price-to-book valuations are near 40-year lows.

– **Value to outperform growth.** We prefer value relative to growth (see Fig. 3.2). P/E multiples for US value relative to growth stocks are near a post–2002 low. Sector considerations also play a key role in our thinking: we overweight energy and financials, which make up one-third of the Russell 1000 Value Index, whose earnings growth looks poised to exceed historical norms relative to the Russell 1000 Growth Index.

Fig. 3.2

We expect US value to continue outperforming growth

Performance difference of Russell 1000 Value stocks and Russell 1000 Growth stocks, year-to-date in %



Source: Bloomberg, UBS, as of 20 November 2018

John Salvino, Unsplash

– **Take advantage of volatility.** An equity buy-write strategy involves purchasing a stock or basket of stocks while systematically selling call options. Over an economic cycle, equity buy-write strategies generate attractive risk-adjusted returns, as they capture both the equity and volatility risk premiums. They are most appealing in current market conditions, when volatility is higher and prospective equity returns are moderate.

The tech view
Strong secular growth prospects, especially in cloud computing, remain intact. And the near-term outlook for enterprise spending has stayed favorable, given continued business optimism. But the smartphone market has matured. Rising trade tensions could also hurt hardware-exposed companies. We believe a neutral allocation to the sector is appropriate at this time.

European equities

Eurozone profits are being pressured by higher input costs and exposure to a slowing China. The best opportunities we see are centered in the energy and utilities sectors, in quality and sustainable dividend stocks, and in Swiss real estate funds.

– **Energy and utilities should defy the gloom.** Strong cash flow growth, an attractive dividend yield, and solid balance sheets, in combination with our expectations for higher oil prices, make for a compelling investment case for the European energy sector. Utilities should also be well positioned for an uncertain environment, with limited sensitivity to ongoing trade disputes and slowing growth in the US and emerging markets.

– **Multi-factor strategies.** In a more challenging investment environment, we favor multi-factor strategies which combine single styles (i.e. value, growth, quality, high dividend yield, momentum, small caps, low volatility). Multi-factor strategies are more resilient than the overall market to higher volatility and to leading indicators rolling down. Since 2001, they have offered better risk-return ratios and have outperformed during MSCI EMU drawdowns.

– **Sustainable high dividends.** Negative interest rates in the Eurozone and Switzerland mean companies paying sustainably high dividends are appealing. We also advocate a diversified dividend strategy in the UK, which should keep returns competitive even if the Bank of England raises rates.

Panachaiko, Greece. Jason Blackeye, Unsplash

The view on financials
Valuations look compelling, with a price-to-earnings ratio of just 9.3x. But we struggle to identify a catalyst for that value to be realized. Concerns about the European Central Bank potentially delaying rate rises, and worries about below-average credit provisions, are likely to hamper performance.

Swiss equities

Amid global turbulence, we see three key areas of opportunity in Swiss equities:

1. **Swiss high-quality dividends.** Swiss dividend-paying equities yield much more than Swiss franc bonds (see Fig. 3.3). Robust balance sheets and profitability also suggest distributions are sustainable, and dividends tend to be more stable than earnings, making this a good strategy in uncertain times. Our current strategy is based on a combination of dividend sustainability, above-average dividend growth, and a relatively attractive yield level.

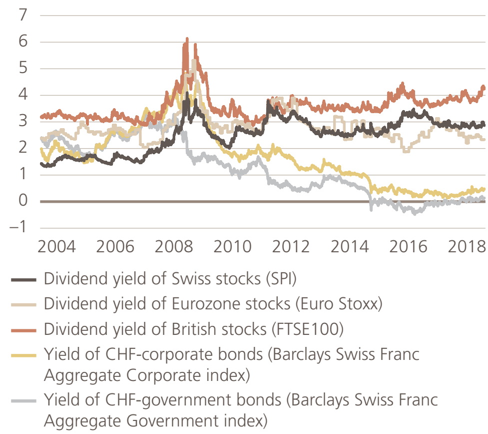
2. **Withholding tax-free distributions** represent an opportunity in early 2019. Since 1992, Swiss companies have been allowed to pay distributions free from withholding tax. We expect 36 of 100 Swiss companies we examined to do so in 2019. Our analysis shows that companies that pay withholding tax-free distributions have a favorable total performance track record, especially from October to May.

3. **Real estate funds** can satisfy those hungry for yield. This asset class is distinctive to Switzerland, and is not technically an equity. These funds, which offer access to a portfolio of properties, deliver a distribution yield of around 3%. The income stream is well supported by a stable economy, rising office employment, and a gradual slowdown in residential construction. We also do not expect property values to fall over the next six to 12 months.

Fig. 3.3

Attractive dividend yield in Europe

Yields in %



Source: FactSet, UBS, as of 8 November 2018

For more on the outlook for the Swiss economy and CHF assets in 2019, visit ubs.com/outlook-ch-en

(Report may not be available in all regions based on suitability).

Emerging market equities

Concerns about rising interest rates, slower Chinese growth, and the US-China trade dispute drove a sell-off in emerging markets in 2018. Headwinds and volatility will continue, but opportunities exist. Emerging market (EM) value stocks could be poised for a catch-up, while in APAC we see specific opportunities in South Korea, Vietnam, and Chinese "old economy" stocks.

Vietnam. Qui Nguyen Unsplash

– **Value stocks could be ready for a catch-up.** Since 2012, the MSCI EM Value Index has underperformed its growth counterpart by 22%. The index's price-to-book ratio of 1x represents a 59% discount to the growth index's against a 10-year average of 49%.

– **Brazil is worth monitoring.** The country has a new president with a strong mandate, and stocks have already rallied on hopes of reform. The political situation remains uncertain and more clarity is needed before we'd advise increasing exposure to the market, but it could advance further if the government succeeds in putting the nation's pension system on a more sustainable footing.

– **Consider indirect EM exposure.** Investors who want exposure to EM economies, but dislike the volatility of EM stocks, could consider both Eurozone and US stocks with at least 20% exposure to emerging markets.

APAC equities

The Chinese economy is slowing and sentiment toward the country is fragile, but valuations are attractive. We see several ways to approach Asian equities in 2019:

1. **First in, first out?** Prices retreated sharply in 2018 despite earnings rising 11%. MSCI China is trading below its long-term average P/E of 12x, and MSCI Asia ex-Japan is just 20% above crisis-level price-to-book ratios (see Fig. 3.4). We expect 5–10% earnings growth in 2019; if and when sentiment turns, asset prices could bounce back quickly.

2. **In with the old, too.** "New China" stocks were battered by trade, growth, and regulatory risks in 2018. We still think themes like e-commerce and video gaming offer excellent long-term prospects. But China's "old economy" doesn't always underperform. Stimulus boosts the case for the infrastructure sector, as well as for banks, which are inexpensive and offer attractive dividend yields.

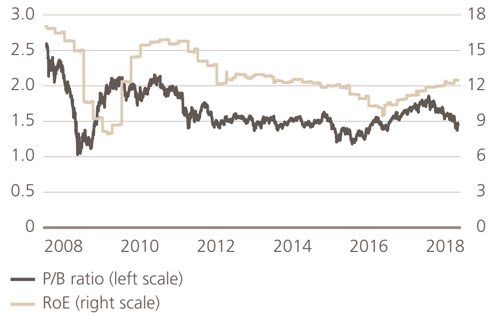
3. **Opportunities from tariffs.** South Korean stocks may rebound as tech players fill the gaps created by US restrictions on Chinese manufacturers. That same dynamic could also boost Japanese semiconductor and machinery makers. The migration of the low-end supply chain from China could accelerate in Vietnam and across South East Asia. And if trade tensions were to spread, investors may pivot to equities in domestic-oriented economies like India.

For more on our outlook for Asia-Pacific in 2019, see Investing in APAC: Navigating turbulence

Fig. 3.4

Valuation support for Asian equities

The MSCI Asia-ex Japan Index's price-to-book valuation unduly discounts a sharp decline in return on equity



Source: Bloomberg, FactSet as of 7 November 2018

Sustainable equities

Sustainable investing (SI) is a philosophy that can be applied to most asset classes. Investors' values do not tend to fluctuate across economic cycles, reinforcing our expectations that assets in SI strategies may prove more stable than conventional strategies in periods of higher volatility. Although the SI philosophy is durable throughout an economic cycle, as the cycle matures investors should adjust their portfolios to account for evolving market conditions. Those seeking to rebalance or build up their SI equity exposure can keep the following observations in mind:

Paxson Woelber, Unsplash

– **A core SI portfolio.** Adopting SI across an entire portfolio enables investors to adjust their exposure to equities and fixed income in a tactical way without compromising their SI focus. The SI asset allocation framework we have developed helps them do so. Investors can still use conventional instruments to protect their positions where there is no SI alternative available, and consider these as "satellite" to a "core" SI allocation.

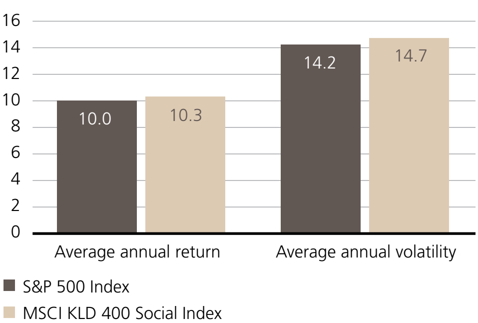
– **Mind the quality.** Various strategies within SI equities offer considerable latitude to investors who want to diversify across approaches. SI approaches that focus on environmental, social, and governance (ESG) "leaders" have traditionally had a quality bias, which can make portfolios more resilient through the cycle. But the evolution of ESG "thematic" approaches, and strategies that focus on identifying companies experiencing an uptick in sustainability performance (ESG "improvers"), can help diversify a portfolio across regions and market capitalizations. Investors should pay attention to how thematic approaches are defined, however, as approaches with narrow definitions may experience higher volatility in choppy markets.

As a rule, we believe that SI strategies will perform in line with traditional investments over the longer term (see Fig. 3.5). But at any given point in the cycle, performance may vary as a result of different instruments and approaches, and some of the newer types of SI instruments and approaches have yet to be tested over an entire cycle.

Fig. 3.5

Sustainable investing strategies have provided returns comparable to traditional strategies

Comparison of S&P 500 Index and MSCI KLD 400 Social Index (sustainability equivalent of S&P 500)
30 April 1990–31 October 2018, in %



Source: Bloomberg, UBS, as of 31 October 2018

Sustainable equity strategy definitions

ESG leaders equities: This strategy allocates the equity component of your portfolio to the stocks of companies that demonstrate superior performance on ESG criteria.

ESG thematic equities: This strategy aims to identify specific themes related to ESG issues, determine which industries and companies benefit from or directly address them, and construct portfolios of stocks according to the thematic framework.

ESG improvers equities: This strategy seeks to identify and invest in the equity of listed companies whose performance on material ESG issues is improving and likely to continue doing so.

ESG engagement equities: Active fund managers use this investing strategy to engage with the companies they invest in as a core element of their approach. They seek to achieve an incremental social and environmental impact and address the challenges as outlined by the UN Sustainable Development Goals (SDGs).

Longer-Term Investments

In an environment in which growth is becoming harder to find, our Longer-Term Investments (LTIs) offer thematic ideas based on secular trends like population growth, aging, and urbanization, particularly in emerging markets. These themes can help investors look through short-term market noise. Entering 2019, our top LTIs are Space, Medical devices, Fintech, and Silver spending.

While LTIs take a longer-term view on secular trends, companies exposed to the trends are still subject to short-term economic fluctuations. To help identify our highlighted themes for the year, we analyzed valuation and momentum indicators, augmented by qualitative screenings. We currently favor a combination of aggressive growth themes, along with those of a more defensive nature to insulate against volatility:

- **Space:**  The sharp decline of launch costs is lowering entry barriers to space (see Fig. 3.6). We forecast the space economy growing from USD 340bn to almost USD 1trn in the next couple of decades. Key catalysts are reusable rocket technology and the deep pockets of, and sustained capital investment by, billionaires.

- **Medical devices:**  Growth of the over 65 age group supports demand in developed economies, while rising affordability and better healthcare system funding will lead to greater penetration in emerging markets. We foresee a sustainable rate of mid-single digit revenue growth.

- **Fintech:**  Driven by rapid urbanization, strong demand from millennials, and favorable regulations, global fintech is at an inflection point. Industry revenues are forecast to grow to USD 265bn in 2025 from USD 120bn last year.

- **Silver spending:**  Compared to younger age groups, "silver spenders" allocate more disposable income to different markets, such as leisure, tourism, and consumer personal care.

We advise investors to diversify within specific LTIs to reduce their exposure to individual companies. Many of them included in these themes are small or medium sized, which increases not only the potential to outperform traditional benchmarks but also vulnerability to drawdowns in a volatile environment. We also recommend diversification across multiple themes to reduce drawdown risk.

Lake Louise, Canada. Shane Hauser, Unsplash

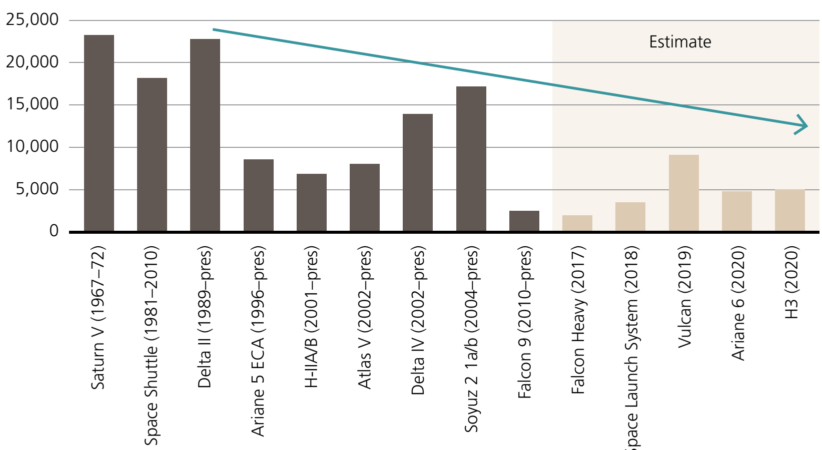
Top Longer-Term Investments for 2019

- Space
- Medical devices
- Fintech
- Silver spending

Fig. 3.6

Falling launch costs are shaping space commercialization opportunities

Cost per kilogram to low earth orbit, in USD



Source: Company data, FAA, UBS as of 2017

Bonds

A maturing cycle can be perilous for bond investors as labor markets tighten, corporate leverage increases, and central banks restrict policy. That said, bonds can provide returns and help stabilize portfolios. We see particular opportunities in long-duration US government bonds and Asian high yield. We also favor euro "synthetic credit exposure," a strategy that offers exposure to corporate credit by selling credit default swaps instead of buying cash bonds. Various investment vehicles, such as notes, can provide access to this market.

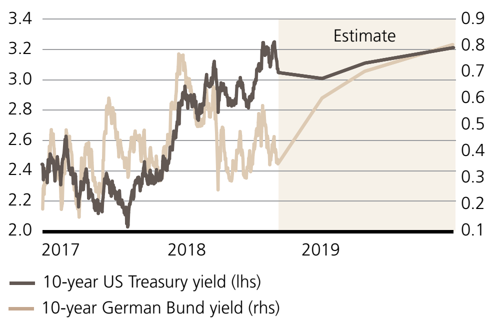
Toronto, Canada. Filip Mroz, Unsplash

- **Rate risks well priced.** Developed market government bond yields reflect central bank policy well, in our view. We expect 10-year US yields to remain close to today's 3.1% by late 2019, and forecast 10-year Bund yields to rise only modestly to 80bps by then, from 40bps at present (see Fig. 4.1).
- **Equities tend to outperform credit late in the cycle.** USD high yield and investment grade bonds have returned an average of just 4% and 1% p.a., respectively, above cash at this stage of the cycle (when both earnings and debt are rising), versus 11% for US equities, based on data since 1990.

Fig. 4.1

Rate risks look well priced

10-year US Treasury yields and 10-year German Bund yields, with 12-month forecasts, in %



Source: Bloomberg, UBS, as of 20 November 2018

Our key ideas for bonds in the coming year are:

1. **US Treasuries**
   (see page 40)
2. **Euro synthetic credit exposure**
   (see page 40)
3. **Asian high yield bonds**
   (see page 43)

– **Avoid excessive corporate credit risk.** Tighter policy will cause investors to focus more on fundamentals. We don't see any catalyst for default rates increasing much in 2019. But amid rising US corporate leverage and historically tight credit spreads, we advise avoiding excessive corporate credit risk and selecting only those bonds that sufficiently compensate investors for the risks of a mature cycle.

For our rate and bond yield forecasts, see page 65.

Long-term outlook

Fixed income has delivered impressive returns for the past seven years, but monetary tightening in the coming years will make it hard to repeat this performance. Certain strategies could nonetheless appeal to fixed income investors with a long-term horizon.

– **Intermediate duration US government bonds should provide positive long-term returns and some portfolio protection.** They have already come close to pricing in a full Federal Reserve rate cycle, in our view, and as a result we expect the 5- to 10-year tenor to offer positive total returns. They could also provide some recession insurance, provided non-US investors hedge their currency exposure (see page 49). If the US economy contracts, the Fed, unlike the European Central Bank (ECB), has the scope to cut rates. The dollar may fall but bond prices would rise in USD terms.

– **Despite the short-term challenges they face, US loans feature appealing long-term risk-return profiles that are among the most promising in developed markets.** An advanced corporate leverage cycle limits their near-term appeal, but loans have a high recovery rate on average in the case of credit events (we estimate 65% vs. 40% for high yield bonds). They are also generally less volatile than other risky credit assets. We estimate average annual returns for this asset class of around 6%–7% p.a. over a full market cycle.

– **US dollar-denominated EM sovereign bonds constitute an appealing opportunity.** With yields 400bps above US government debt, this asset class, in our view, should offer among the highest returns in fixed income markets in the coming market cycle, despite near-term challenges as EM growth slows.

Developed market bonds

Central bank policy is generally well priced by government bonds, but risks remain. At 45% of GDP, debt held by non-financial US firms is at its highest on record. We do not expect credit conditions to deteriorate significantly, but fundamentals are likely to continue to worsen. Within developed markets we like long-duration US government bonds and euro synthetic credit exposure.

- **Consider US Treasuries.** As markets become more turbulent, securities with higher credit quality can help dampen portfolio volatility: long-dated Treasuries tend to rally when stocks suffer corrections (see Fig. 4.2). A 3.2% yield should also help mitigate valuation losses if rates spike higher, although we think that the likely rate hikes are largely priced in.

- **Euro synthetic credit exposure is well placed to gain.** This credit strategy offers exposure to corporates by selling credit default swaps instead of buying cash bonds. The valuations of euro corporate bonds have been artificially elevated by the ECB's bond-purchase program. We favor such a synthetic strategy over a traditional bond strategy currently, at least until the ECB unwinds its EUR 170bn corporate bond portfolio. Given the lower volatility of synthetic instruments, we recommend holding them to maturity.

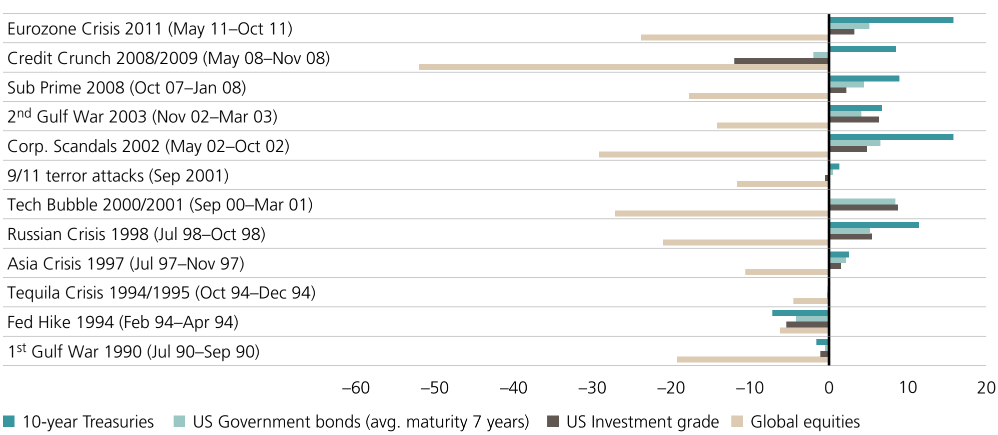
- **Review US senior loan exposure.** This asset class is attractive over a multi-year time frame (see page 39). But investors should review their exposure to it in 2019 given the limited price upside, weaker credit quality, and liquidity considerations. M&A issuance has increased and leverage on those deals has reached 5.8x debt-to-EBITDA (not adjusted for potential synergies), a high since S&P started collecting data in 2006. European loans offer current yields of 4% (in EUR) and 7% (hedged into USD), which are attractive given the continued low default rates we anticipate.

Jökulsárlón, Iceland. Rolf Gelpke, Unsplash

Fig. 4.2

US Treasuries can provide an effective cushion in risk-off periods

Return in %



Source: Bloomberg, UBS, as of October 2018

Emerging market bonds

Emerging market (EM) bonds faced challenges in 2018. US rate hikes compelled about half of EM central banks to follow the Federal Reserve in raising rates, and worries about Chinese growth weighed on the asset class. But with yields now higher and Fed hikes better priced in, we see value in EM USD sovereign bonds and Asian high yield, and anticipate opportunities in countries enacting investor-friendly reforms, like Brazil.

Mumbai, India

– **Value in EM bonds.** Many investors do not hold sufficient allocations to EM credit in their portfolios. But the Emerging Market Bond Index (EMBI) trades on an attractive 400bps spread over US Treasuries, above its average since 2010 of 350bps, while most developed market credit segments trade well below their long-term averages. By choosing USD-denominated rather than local currency debt, investors are also better cushioned from EM currency volatility.

– **Opportunities in beaten-up bonds.** The past year was one of financial turbulence in Turkey and Argentina. But such crises can create opportunities. In 2019, investors should watch for occasions when EM debt appears oversold. Whenever nations take major steps to address investor concerns, longer-duration bonds can gain from improved perceptions about the long-term outlook.

– **Keep an eye on Brazil.** The incoming president has proposed a range of economic reforms that could improve Brazil’s fiscal sustainability. If they come into effect, they could reduce the risk premium that investors demand for allocating funds to the country.

APAC bonds

Investors seeking yield in Asia-Pacific faced a challenging environment in 2018. But with yields now higher, we see selective opportunities in the year ahead:

- **Asian high yield.** Chinese issuers account for about half of the Asian high yield credit market, and fears of an economic slowdown made investors pessimistic about the asset class in 2018. As a result, Asian high yield credit now offers a yield of almost 9% (see Fig. 4.3). China's growth will slow, but we think the country is likely to avert an economic hard landing, with Beijing's gradual shift to more supportive policies cushioning the slowdown.
- **Bargain hunting.** The spread between Asia BBB and A-rated bonds has been as tight as 50bps, but it is has now widened to near 100bps. With Asia investment grade likely to be fundamentally stable, we like selective BBB government issuers in China, and Tier 2 financials in Asia, with yields near 5% for bonds with durations of three to five years.
- **Two ways to play.** Given we expect a modest slowdown rather than a hard landing in China, we would view modest drops in valuations as opportunities to pick up high-quality credits. In the event of a sharp sell-off, we would search for credits that offer yields at double-digit rates while looking likely to ultimately survive the storm.

Fig. 4.3

Asia HY competitively priced as yields approach 9%

JACI High Yield Index yield-to-maturity in %

Source: Bloomberg, JP Morgan, UBS, as of 1 November 2018

Sustainable bonds

Fast growth of issuance and strong demand have expanded the range of sustainable investing (SI) bonds in recent years, with the pace of innovation accelerating as the fixed income market catches up to the more advanced SI equity offerings. As it stands, investors now have the solutions necessary to build a sustainability-oriented portfolio that mirrors traditional fixed income offerings.

In the face of a maturing cycle, our sustainable bond strategy recommendations mirror those adopted in our broader bond outlook (see page 39). But there are several unique aspects to SI fixed income that we believe investors should keep in mind for the year ahead:

- **Sustainable liquidity.** Greater market uncertainty may tempt some investors to retreat to more traditional instruments like US Treasuries. But they should also note that issuance from multilateral development banks (MDBs) generally offers liquidity and safe-haven qualities similar to sovereign bonds without sacrificing the chance to promote sustainability goals (see Fig. 4.4). An analysis of yield premiums on medium to longer-dated World Bank bonds reveals only moderate volatility that ranges between 13bps and 20bps across the curve over the last few years, with only short-term spikes above 50bps during periods of severe market stress.

- **Don’t compromise on performance.** The exclusionary approach to ESG bond investing championed by some managers can lead to notable underperformance versus traditional benchmarks. UBS recommends more sophisticated approaches that prioritize sustainability factors while aiming to deliver market-rate returns that balance conventional risk and market factors against high ESG ratings. Our green bond offerings and ESG leaders theme both seek to match traditional bond market performance over a cycle. Tactical considerations, like our preference for long-dated US government bonds, can be implemented with global MDB bonds and select green bonds alike.

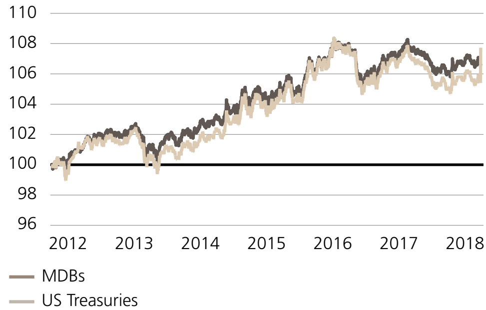
Sermersooq, Greenland. Annie Spratt, Unsplash

– **Selectivity in green bonds.** Green bond issuance nearly doubled in 2017 to more than USD 160bn and continues to rise, according to the Climate Bonds Initiative. But independent auditing and verification remains voluntary, so understanding the actual environmental impact that the use of green bond proceeds depends on transparency, reporting, and third-party verification. Investors should take care to understand the criteria of the funds or individual bonds they buy. Issuers who align their objectives less with those of investors will likely come under increasing scrutiny.

Fig. 4.4

Development bank bonds have matched the return on US Treasuries

Solactive UBS Global Multilateral Development Bank Bond Index vs. US Treasuries (intermediate maturities), from base 100 return in %



Source: Bloomberg, UBS, as of 9 November 2018

Stanley Beach, Hong Kong.

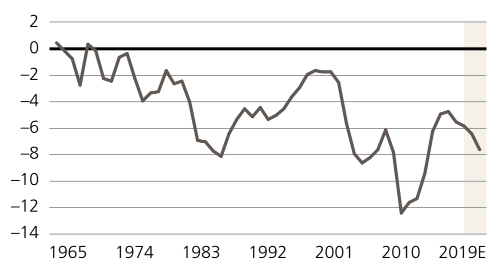
Currencies

Higher US rates in a maturing cycle have pushed rate differentials to record levels, supporting the US dollar. While we expect the greenback to retain its strength in the near term, we think the dollar is likely to depreciate over time as policy normalization gets underway in Europe and Japan.

Fig. 5.1

The US twin deficit continues to grow

US current account deficit and CBO budget balance as % GDP



E = Estimate

Source: Bloomberg, CBO, UBS, as of 7 November 2018

Euro vs. US dollar

The USD remains overvalued thanks to marked positive short-term interest rate differentials as the Federal Reserve continues to raise interest rates. This state of affairs, along with the dispute over Italy's budget, is likely to prompt further near-term gains for the USD relative to the EUR. But looking further ahead, we expect the Fed to near the end of its rate-hiking cycle in 2019, while the European Central Bank (ECB) will only be starting to normalize interest rates, which will cause the differentials to shrink and the dollar's advantage to recede, in our view.

The support for US growth from fiscal stimulus will also wane next year, and the US twin fiscal and current account deficits are likely to start to weigh on the dollar (see Fig. 5.1). We forecast EURUSD at 1.15 and 1.20 over six and 12 months. A key risk to our view is the US launching a large infrastructure program, which could boost growth and inflation. The dollar could also remain stronger relative to the euro if US-China trade frictions intensify in 2019, Eurozone data slows, or the ECB appoints a dovish successor to current president Mario Draghi.

Swiss franc

Longer term, we expect the Swiss franc to depreciate versus the euro but appreciate against the US dollar. Amid global uncertainty, the Swiss National Bank (SNB), we think, will only raise its target rate after a first rate hike by the ECB. But scope for Swiss franc depreciation versus the euro is limited, in our view, as we anticipate the SNB hiking rates in sync with the ECB and reducing its balance sheet in the long term. In short, we see EURCHF moving toward 1.20, but would be surprised by a major overshoot. Our six and 12-month forecasts for EURCHF are 1.15 and 1.20.

For more on the outlook for the Swiss franc and its impact on the Swiss economy in 2019, visit: ubs.com/outlook-ch-en

(Report may not be available in all regions based on suitability).

Stanley Beach, Hong Kong

Chinese yuan

Against a backdrop of ongoing US-China trade tensions, slowing Chinese economic growth, and a diminishing current account surplus, we think the Chinese yuan is likely to decline by another 5% in trade-weighted terms during 2019. Our USDCNY forecasts are 7.1, 7.2, 7.3 over three, six, and 12 months. The risk to our forecasts is two-sided: if the US implements tariffs on another USD 267bn of Chinese imports, USDCNY could test 7.5. Conversely, if a trade deal is reached and tariffs are reduced, lower uncertainty could push the CNY toward a 6.5–6.8 range versus the USD.

Japanese yen

Abenomics has weakened the yen significantly. It is currently more than 30% undervalued relative to its estimated equilibrium purchasing power parity (PPP) (see Fig. 5.2). As inflation normalizes and the Bank of Japan (BoJ) starts to discuss withdrawing monetary stimulus, we think the JPY could start to strengthen again. Differentials in 10-year yields between the US and Japan are also an important influence on USDJPY. Looking ahead, we see limited further upside for 10-year US yields (our 12-month forecast is 3.2%), but Japanese yields could rise as the BoJ starts to slowly normalize its monetary policy. We overweight the yen as we enter 2019, and our USDJPY forecasts are 110, 107, and 105 over three, six and 12 months.

For our currency forecasts across a range of key pairs, see page 66.

To hedge or not?

The decision about whether to hedge currency exposure depends on how our own estimates of long-term value compare with foreign exchange forward rates. For example, at present we see the Japanese yen as highly undervalued, so we recommend considering holding some outright exposure to it in portfolios.

The wide interest rate differential between the USD and such other major currencies as the EUR, CHF, and JPY has made it seem attractive for investors not to hedge the USD currency exposure attained from buying US assets. But we think overseas investors should still hedge their USD exposure. Over the economic cycle we expect the benefits of higher USD carry to be more than offset by: a) medium-term dollar depreciation, and/or b) the increased portfolio volatility that comes from not hedging overseas currency exposure.

Fig. 5.2

The yen is significantly undervalued

USDJPY and purchasing power parity value since 1982

Source: Macrobond, UBS, as of 12 November 2018

Marquette, United States. Alex Perz, Unsplash.

Commodities

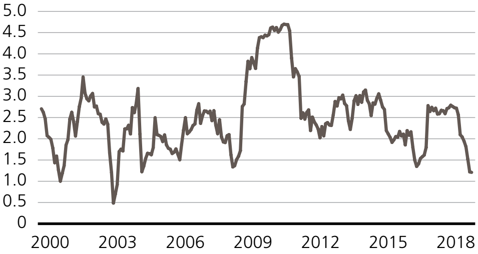
The latter stages of the economic cycle have historically been one of the better times to invest in commodities. Overall demand tends to stay high while inventories run low. In the six months prior to the last three US recessions, a diversified basket of commodities* outperformed global equities by an average of 15%.

*(BCOM and CRB Indexes)

Fig 6.1

Dwindling spare capacity

Spare capacity in Saudi Arabia, UAE and Kuwait, in million barrels per day



Source: IEA, as of 1 October 2018

Oil

Since climbing to a four-year high, oil prices have been pressured in late 2018 by rising US oil inventories and rapid supply growth. Production is at record levels in the US and at post-Soviet highs in Russia. Deteriorating macro and trade dynamics are likely to curb demand growth in 2019. And the Trump administration has recently displayed some sensitivity about how its policies have affected prices.

But we believe the market's cautious turn is overdone. US sanctions cut a million barrels of Iranian oil from the market at the end of October, a number that will increase. Saudi Arabia has vowed to maintain an equilibrium, but this will push global spare capacity to a 10-year low (see Fig. 6.1). And US shale production will be tempered by distribution constraints, with new pipelines only expected to come online in the second half of 2019.

On balance, we keep a positive view on crude. Provided OPEC maintains production discipline, we see Brent oil prices at USD 75–80/bbl. But a break between members could see higher production levels, in which case we think Brent would likely trade closer to USD 45–60/bbl.

Gold

As the cycle matures, inflation will likely rise, EM investors will face currency volatility, and real interest rates will peak. Historically, this has lifted the value of gold as a hedge.

We think gold's advance in the first half of 2019 could be limited by a still-strong US dollar. A Fed hike in December will help maintain dollar strength, at a time when the one-year correlation between the trade-weighted USD and gold remains elevated at more than –0.7.

But as 2019 proceeds, a weaker dollar, higher equity market volatility, and signs that the Fed is nearing the end of its hiking cycle should act as tailwinds for gold, which we see climbing to USD 1,300/oz in 12 months. As the cycle advances and volatility picks up, some investors may consider buying more gold for its insurance qualities. We think any dip below USD 1,200 would offer a particularly attractive entry point.

For our forecasts on oil, gold, silver, and copper, see page 66.

Nashville, United States. Drew Beamer, Unsplash

Alternatives

In the years to come stocks and bonds are likely to face higher volatility and generate lower returns than in the past, so the case for holding alternative assets in strategic asset allocations is strong. We seek exposure to low beta and diversified hedge fund strategies, segments of the private market space with reduced leverage and attractive valuations, and select opportunities in impact investing.

Alternatives are important at this stage in the cycle. They serve as portfolio diversifiers, offer exposure to uncorrelated and idiosyncratic return streams, and can add alpha. They can also help reduce behavioral bias and capture illiquidity premiums. Focusing on skillful managers capable of taking a more sophisticated and tactical approach to investing is key.

Hedge funds

With potentially tougher times ahead, we think investors should consider holdings in hedge funds that can diversify their portfolio overall.

The following three principles are key in the current environment:

1. **Diversification.** We recommend avoiding exposure to single strategies and encourage diversifying across strategies and drivers of returns. Multi-strategy funds should be seen as a core portfolio holding at this point in the cycle.

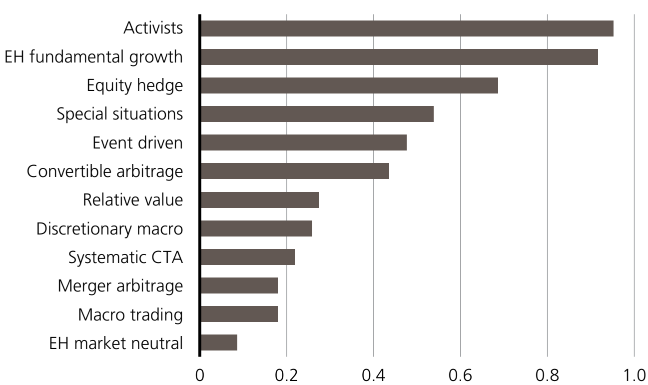
2. **Low directionality.** Low beta tactical managers, or market neutral approaches, can limit the exposure to the direction of equity and bond markets, and should be favored in our view over more aggressive directional ones (see Fig. 7.1).

3. **Idiosyncratic focus.** Relative value strategies that can exploit mispricing or capitalize on arbitrage opportunities look attractive to us, as well as macro managers who can take advantage of periods of increased macroeconomic uncertainty and volatility.

Fig. 7.1

Beta of hedge fund strategies to a 60/40 global equity bond portfolio

Indexes used include HFRI indexes, Barclay Hedge Global Macro, MSCI World ACWI TR, JPM Global Agg Bond Index



Source: Bloomberg, HFR, UBS, data for the period of 31.01.2000 – 31.10. 2018

Private markets

Investors who can keep part of their portfolio in less-liquid investments should seek a longer-term allocation to private markets, diversified across managers, regions, and vintages to reduce single-strategy risk. In today's maturing cycle, we recommend:

- **Being selective on credit.** While we advise maintaining diversified exposures long term, in today's market we see value in strategies that can opportunistically deploy capital to take advantage of dislocations in less explored markets, and where manager underwriting and underlying complexity are rewarded.

- **Less-crowded equity strategies.** Within private equity, the funds of growth equity managers are less crowded and less leveraged. Portfolio companies typically deliver high organic growth rates and could prove more resilient in the latter stages of the economic cycle.

- **Opportunities spanning over multiple business cycles.** We favor managers that can take advantage of key mega trends benefiting from aging demographics, population growth, and urbanization.

Nashville, United States. Drew Beamer, Unsplash

Impact investing

Impact investing – which pursues competitive financial returns alongside measurable, intentional, and verifiable environmental or social impacts – aligns well with private market investments. A growing number of mainstream private equity managers are now launching large-scale commercial impact funds.

- **Long-term, large market opportunities.** Sustainable themes including those aligned with the UN SDGs present large market opportunities that should be inherently less correlated with broad market movements. The scale of the challenges being tackled by these goals suggests large potential that can be addressed through highly commercial solutions.

- **Potentially less efficient pricing.** Impact private market investments are often less efficiently priced than public market assets. Companies with an environmental or social mission often prefer to partner with investors who share their vision. This can mean access for dedicated impact fund managers to attractive deals – potentially increasing their alpha opportunities. And their deployment of capital over multiple years offers flexibility if adverse market conditions lower valuations in the near term.

- **Tangibility of impact depending on chosen approach.** Investors seeking impact in addition to financial returns can also invest directly in companies, which provides a closer touchpoint to the targeted impact, but also carries concentration risk and potentially demands more time and resources. Fund-based impact investing, by contrast, offers diversification benefits, less individual asset risk and potential for alpha from manager value-add, while funding companies whose growth coincides with their ability to generate social and environmental change.

Private market impact investments may not necessarily be a fit for portfolios with high liquidity requirements. However, they offer clear benefits to investors who think and invest long term and are interested in contributing to positive change in society and the environment – and seek to earn compelling returns while doing so.

London, United Kingdom. Evelyn Paris, Unsplash

Geneva, Switzerland. Samuel Zeller, Unsplash

Real estate

The advanced stage of the cycle means low rental yields and falling transaction volumes for real estate. Total returns now rely on income rather than capital growth. E-commerce distribution and co-working have supported demand for commercial real estate, but slower growth and/or higher rates could push values lower.

Residential real estate

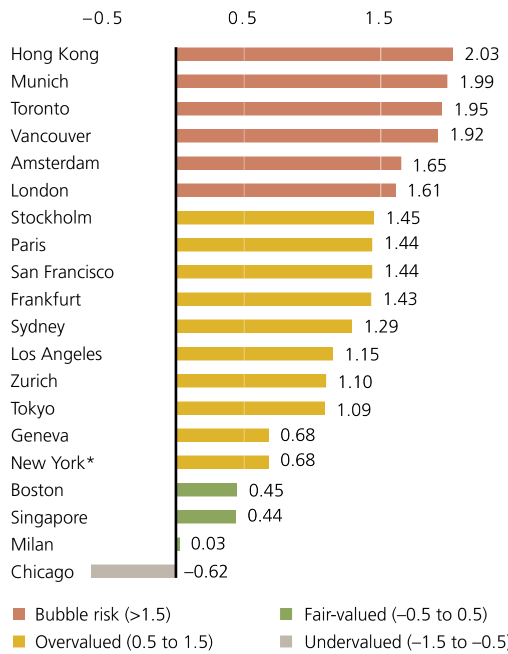
China. Weaker market sentiment and an uncertain economic outlook might dampen demand for new homes in tier 1 and leading tier 2 cities. We see a risk that prices could fall by a low to mid-single digit percentage, followed by a sharper decline in transaction volumes. A more dramatic fall would probably prompt government action to counteract it, given the potential political sensitivity.

Hong Kong and Singapore. The US-China trade spat and expectations of a weaker Chinese economy have already led Hong Kong owned-home prices to fall by around 5ppt from their August peak. Similar concerns, and government measures to cool the property market, have halted home price rises in Singapore. A major price correction remains unlikely in both cities, although our Global Real Estate Bubble Index reveals that fundamentals in Singapore ("fairly valued") are stronger than in Hong Kong, which is the city with the greatest bubble risk in our index (see Fig. 8.1). We expect Singapore prices to move in a +/–2% range in 2019. In Hong Kong we anticipate prices falling by 10%–15% in the next six to 12 months.

Fig. 8.1

UBS Global Real Estate Bubble Index

Latest index scores for the housing markets of select cities



Source: UBS * Index altered due to data source revision.

Charleston, United States. Landon Martin, Unsplash

London. The Bubble Index score declined here for the second year in a row, although it remains in the bubble-risk zone. Strained affordability, political uncertainty, and a less favorable tax environment for international and buy-to-let investors has kept housing demand in check. That said, from the perspective of foreign investors, house prices in USD terms have retreated by 10% since 2015 and could constitute an attractive buying opportunity. We see prices stabilizing but still advise caution given high market valuations and marked political uncertainty.

US. A divergence has opened up between the East and West Coast. Annual inflation-adjusted prices in New York have fallen 2% over the last four quarters, the first decline in several years. Rising mortgage costs, negative net migration, and fewer tax breaks have weighed on prices. In contrast, Los Angeles and San Francisco have been buoyed by tech company expansion. Looking forward, we consider it likelier that the gap will narrow because of the West Coast market weakening rather than the East Coast strengthening.

Switzerland. With inward migration having declined in recent years and the construction of new property remaining high, the risk is that higher net supply will hamper prices. Apartment prices in Zurich have declined by around 2% in the last year. But with neither Zurich nor Geneva in bubble-risk territory and interest rates low, a significant price correction appears unlikely.

Commercial real estate

Prime initial yields on core property have converged across cities, countries, and sectors over the last two to three years, irrespective of local financing costs. They are now similar worldwide at about 4%. Cash-rich buyers without refinancing needs, such as sovereign wealth and pension funds and other institutional investors, might still view this yield as attractive for fully let, well-located buildings. But investors should not expect capital gains over a five-year time horizon unless rental income growth accelerates, which is not our base case.

US/Europe. The balance of supply and demand is not a major issue in either region. The risk of greater supply hitting occupancy rates is higher in the US, where real estate tends to be financed more by the credit markets. And the trend of increased urbanization is stronger in Europe than the US and likelier to offer greater benefits there because the stock of investable property is more concentrated. Overall, fundamentals look healthier for office, residential, and logistics real estate, while retail is increasingly polarized, especially in the US, which is facing oversupply. European retail is better balanced overall, although UK retail is beset by challenges.

Switzerland. Vibrant employment growth boosted the office sector in 2018, so the weakness of recent years seems to have faded. Select office purchases may offer limited upside, but investments in retail are comparatively unattractive, given intense online competition. We expect rents to decline by 2%–3% this year, and see new and modern retail space crowding out existing assets.

APAC. In general, investment demand in APAC is driven by prospects for capital appreciation rather than rental yields, but at this stage in the cycle the scope for capital gains is deteriorating. Concerns about a China slowdown and the US-China trade standoff are likely to diminish investor appetite for risk. Initial yields for existing and fully let commercial properties in the most liquid markets lie below average refinancing costs in China and even Hong Kong, so transactions are increasingly being made by cash-rich institutional investors.

Liquidity. Longevity. Legacy.

The 3Ls

Skógafoss Waterfall, Iceland. Elisa Martínez, Unsplash

The latter stage of an economic cycle is the best time to lay the foundations of your financial plan – before the next downturn. Many investors make their costliest errors during transition points in the market cycle. Our Liquidity. Longevity. Legacy. (3L)* approach to wealth management can help you plan for your long-term goals while reducing the danger of falling prey to costly decisions during downturns.

The 3L framework (see Fig. 9.1) allocates your wealth into three strategies:

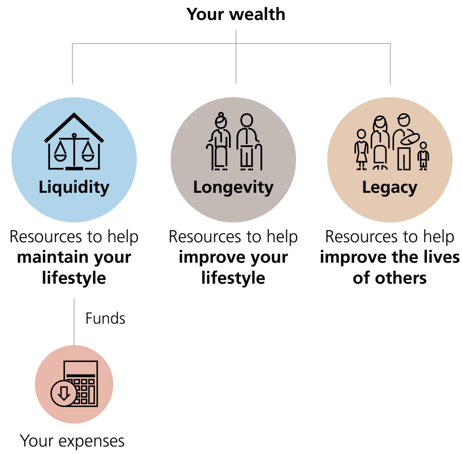
1. **Liquidity.** A Liquidity strategy is designed to fund expenditures and meet liabilities for the next two to five years. Investments should be held in safe assets with low volatility, typically cash and/or a high-quality bond ladder.

2. **Longevity.** A Longevity strategy helps you meet your financial goals for the balance of your lifetime, and is characteristically well-diversified across asset classes with a growth orientation. The exact composition of the portfolio depends on your situation, goals, financial personality, and values.

* Timeframes may vary. Strategies are subject to individual client goals, objectives, and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

Fig. 9.1

The 3L framework



Source: UBS

3. **Legacy.** A Legacy strategy is for assets in excess of what you need to meet your lifetime objectives. Its investment portfolios can be both more aggressive and could be less liquid than those in the Liquidity or Longevity strategies since the time horizon it is designed for is usually measured in decades.

The right allocation at the right time

The 3L approach is a blueprint for families who want to understand how they can better allocate their assets and manage their liabilities to help meet specific goals and objectives.

The relative sizing of each strategy changes over the course of an investor's life:

Pre-retirement, an investor would not hold many financial assets in the Liquidity strategy, as current income typically covers all expenses. The Longevity strategy would be in the process of being filled through savings and growth, and the Legacy strategy would probably still be empty.

Closer to retirement, the Longevity strategy should be completely funded, and some assets might now also be included in the Legacy strategy. The investor should also have started moving assets into the Liquidity strategy in anticipation of losing employment or business income.

* Timeframes may vary. Strategies are subject to individual client goals, objectives, and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

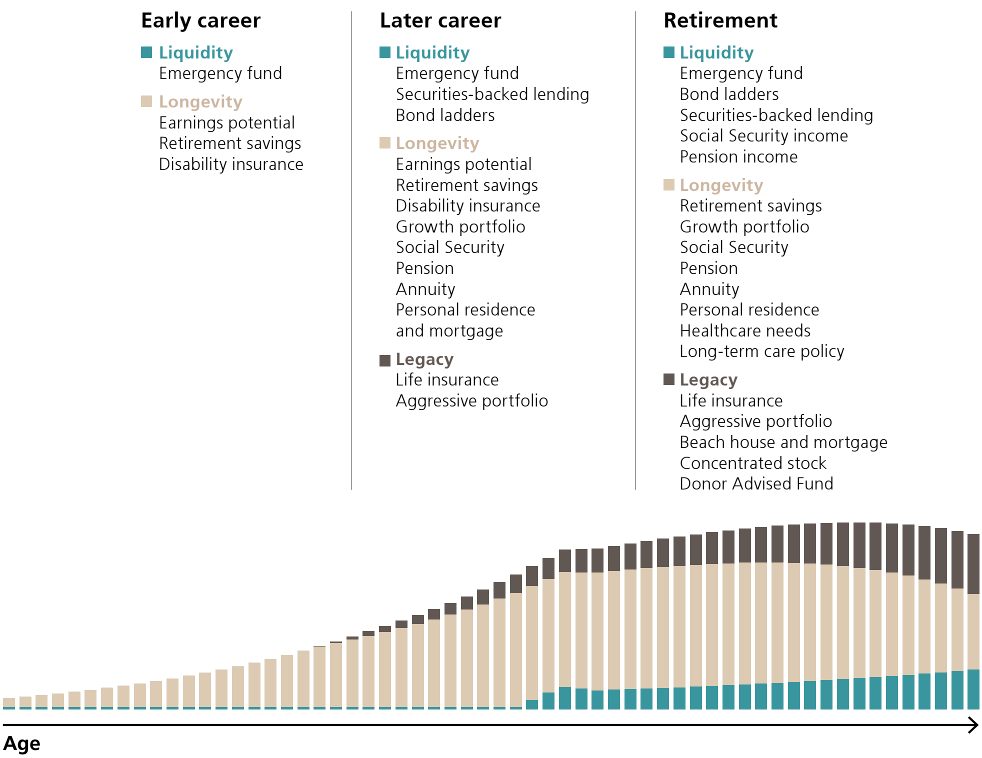
Finally, an investor will slowly spend down his or her Longevity assets during retirement. At the same time, Legacy assets are unencumbered so they can appreciate in value.

Figure 9.2 illustrates this changing segmentation of assets over time for a hypothetical investor.

Fig. 9.2

The relative size of each strategy and the resources that they contain change throughout an investor's life

Illustrative example of hypothetical investor during three distinct life stages



Source: UBS

* Timeframes may vary. Strategies are subject to individual client goals, objectives, and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

Northeast Greenland National Park, Nuuk, Greenland. Annie Spratt, Unsplash

How the 3L framework can help investors navigate bear markets

Most investors loathe equity bear markets. But for those of you still accumulating assets, they actually represent important opportunities to invest in growth at a lower price.

As a result, if managed properly, market downturns – though emotionally difficult – can increase long-term wealth. With the equity bull market aging, now is a good time to ensure sufficient liquidity to avoid being forced to sell assets at depressed levels when the next bear market finally arrives.

The 3L approach can help mitigate such "sequence risk." It enables investors to spend out of their Liquidity strategy during drawdowns. By doing so, they give risk assets in their Longevity strategy time to recover before having to sell them for spending needs.

This effect was illustrated most clearly during the tech crash of 1999–2000. Consider investors who wanted to spend 4% of their initial wealth annually in retirement. If they began filling their Liquidity strategy in 1999 before retiring in 2002, then spent out of their Liquidity strategy, and only refilled it once the Longevity strategy's 60:40 portfolio recovered from the drawdown, they would, by 2017, have had 4% more wealth than if they had spent directly out of their 60:40 portfolio.

Our analysis, which covers the last 80 years, indicates that a disciplined planning-based framework such as the 3L strategy would have added an average of 0.25% in annual alpha during each bear market cycle, by staying invested during sell-offs.[1] The psychological benefit of knowing that your spending needs are separated from market volatility is more difficult to quantify, but no less important.

[1] Source: Liquidity. Longevity. Legacy.: A purpose-driven approach to wealth management. (See Segmenting helps manage through bear markets.)

* Timeframes may vary. Strategies are subject to individual client goals, objectives, and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

Will Turner, Unsplash

Resisting market timing with the 3L framework

Aside from forced selling, the turn of a market cycle can also be problematic due to the temptation to make significant changes to your portfolio at the wrong time. In "Trading is Hazardous to your Wealth," Brad Barber and Terrance Odean found that households with the highest portfolio turnover underperformed average investors by 5% per year, and trailed low-turnover investors by almost 7%.

One way of minimizing risk related to costly emotional behavior is to establish a disciplined investment approach such as rebalancing. While selling top-performing asset classes and buying worse-performing asset classes can be counterintuitive, our analysis shows that establishing a disciplined rebalancing approach within the 3L framework can add an additional 0.8% alpha on an annual basis.

The 3L framework isn't a panacea for solving our own emotional biases, but it does provide a concrete framework for decision-making that investors can fall back on during times of market stress. Investors are likelier to think twice about selling assets associated with long-term objectives. By embedding major financial decisions in specific financial goals and objectives, the framework provides guidance for action during difficult periods.

* Timeframes may vary. Strategies are subject to individual client goals, objectives, and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

Economic forecasts

	GDP growth (%)				Inflation (%)			
	2017	**2018E**	**2019E**	**2020E**	**2017**	**2018E**	**2019E**	**2020E**
Americas								
US	2.2	2.8	2.4	2.0	2.1	2.4	1.5	2.3
Brazil	1.0	1.5	3.0	2.5	3.4	3.7	4.3	4.3
Canada	3.0	2.1	2.5	2.3	1.6	2.3	2.2	2.1
Europe								
Eurozone	2.5	1.9	1.6	1.5	1.5	1.8	1.7	1.6
– Germany	2.5	1.7	1.6	1.5	1.7	1.9	1.8	1.5
– France	2.3	1.6	1.6	1.6	1.2	2.1	1.6	1.3
– Italy	1.6	1.0	1.0	0.9	1.3	1.3	1.0	1.0
– Spain	3.0	2.5	2.2	2.0	2.0	1.8	1.5	1.5
UK	1.7	1.2	1.8	1.3	2.7	2.5	2.1	2.1
Russia	1.5	1.6	1.5	2.1	3.7	2.9	5.4	3.9
Switzerland	1.7	2.9	1.6	1.7	0.5	1.0	1.0	1.0
Asia								
China	6.9	6.5	6.0	6.0	1.6	2.2	2.0	1.8
Japan	1.7	1.0	1.7	1.0	0.5	1.0	1.7	3.0
India	6.7	7.3	7.3	7.4	3.6	4.2	4.6	4.4
South Korea	3.1	2.8	2.6	2.9	1.9	1.6	2.1	1.5
Developed markets	2.3	2.3	2.1	1.9	1.7	2.0	1.7	2.1
Emerging markets	5.2	5.1	4.8	5.1	3.4	4.0	4.3	3.5
World	3.9	3.8	3.6	3.7	2.7	3.1	3.2	2.9

E= Estimate

Source: UBS, as of 28 November 2018

Rates and bonds

	Base rates			10-year yields (%)		
	Current	**End-2018**	**End-2019**	**Spot**	**6m**	**12m**
USD	2.00–2.25	2.25–2.50	3.00–3.25	3.05	3.10	3.20
EUR	–0.40	–0.40	–0.20	0.34	0.70	0.80
CHF	–0.75	–0.75	–0.50	–0.12	0.30	0.40
GBP	0.75	0.75	1.25	1.38	1.60	1.70
JPY	–0.07	–0.05	0.00	0.09	0.20	0.30

Source: UBS, as of 28 November 2018

Commodities

	Spot	6 month	12 month
Brent crude oil (USD/bbl)	60.0	80.0	75.0
WTI crude oil (USD/bbl)	52.0	73.0	68.0
Gold (USD/oz)	1,213	1,250	1,300
Silver (USD/oz)	14.5	15.0	15.5
Copper (USD/mt)	6,122.0	7,250.0	7,000.0

Source: UBS, as of 28 November 2018

Currencies

Developed markets

	Spot	6 month	12 month	PPP
EURUSD	1.13	1.15	1.20	1.31
USDJPY	114	107	105	73
GBPUSD	1.28	1.30	1.36	1.61
USDCHF	1.00	1.00	1.00	0.92
EURCHF	1.13	1.15	1.20	1.21
EURGBP	0.88	0.88	0.88	0.81
AUDUSD	0.73	0.73	0.75	0.70
USDCAD	1.33	1.24	1.22	1.20
EURSEK	10.25	10.00	10.00	9.79
EURNOK	9.71	9.20	9.20	10.49

Source: UBS, as of 28 November 2018

Emerging markets

	Spot	6 month	12 month
USDCNY	6.95	7.20	7.30
USDIDR	14,529	15,500	15,250
USDINR	70.60	75.00	73.00
USDKRW	1,127	1,170	1,150
USDRUB	67.30	68.00	65.00
USDTRY	5.25	5.80	6.50
USDBRL	3.85	3.70	3.70
USDMXN	20.40	19.00	19.00

Source: UBS, as of 28 November 2018

What we got wrong and right

We were positive on global equities heading into 2018, in the context of solid growth, but warned of higher market volatility and higher correlations between equities and bonds, amid the withdrawal of global central bank stimulus.

Global growth momentum carried through 2018 as expected, with a US growth spurt actually pushing its GDP above our forecast (see Fig. 10.1), and warnings of higher volatility and correlations were borne out. The VIX spiked above 25 on seven occasions, with equities and bonds falling together on occasion.

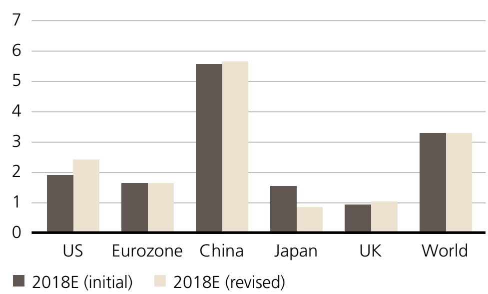
Global equity markets fell short of our expectations, though, down 2% at the time of writing. The dollar also appreciated, against our expectations, and 10-year US Treasury yields moved higher than forecast. This has been in part because the Fed proved more hawkish than anticipated. We initially forecast two hikes in 2018, the final tally looks likely to be four.

This acceleration in the Fed hiking cycle was one of the top three risks we raised, alongside a China debt crisis, and a geopolitical shock. The other two had an impact, too. China's efforts to contain debt risks and deleverage directly fed into a macro slowdown, hurting risk assets across Asia. In geopolitics, the US administration showed a greater willingness to escalate the trade conflict with China than we had expected.

Fig. 10.1

Global growth met expectations this year

Real GDP growth in %, UBS forecasts



E= Estimate

Source: UBS, as of 9 November 2018

Key dates to watch

2018

Dec
- 6 December, OPEC meeting
- 13 December, ECB meeting
- 19 December, FOMC meeting (hike expected)
- 20 December, BoJ meeting, BoE meeting
- 31 December, deadline for Italian budget approval

2019

Jan
- 1 January, US increases tariffs on USD 200bn of Chinese imports to 25%
- 22–25 January, WEF
- 23 January, BoJ meeting
- 24 January, ECB meeting
- 30 January, EC economic forecasts
- 30 January, FOMC meeting

Feb
- 1 February, FOMC meeting
- 4–7 February, EC economic forecasts
- 7 February, BoE meeting
- 17 February, deadline for US investigation on auto imports
- 24 February, Moldovan election (parliament)

Mar
- 7 March, ECB meeting
- 15 March, BoJ meeting
- 20 March, FOMC meeting
- 21 March, BoE meeting
- 29 March 23:00 UTC, Brexit takes effect
- 31 March, Ukraine presidential elections
- 31 March, Turkish local elections

Apr
- 10 April, ECB meeting
- 12–14 April, World Bank and IMF meeting
- 25 April, BoJ meeting
- April or May, Indian general election (date tbd)

May
- 1 May, FOMC meeting
- 2 May, BoE meeting

- 2 May, England and Northern Ireland local elections
- 23–26 May, European parliamentary elections
- 26 May, Belgian elections
- May or June, OPEC meeting (date tbd)

Jun
- 6 June, ECB meeting
- 19 June, FOMC meeting
- 20 June, BoJ meeting
- 20 June, BoE meeting
- 28–29 June, G20 summit in Osaka (Japan)

Jul
- 25 July, ECB meeting
- 31 July, FOMC meeting
- 30 July, BoJ meeting

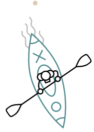
Aug
- 1 August, BoE meeting

Sep
- 12 September, ECB meeting
- 18 September, FOMC meeting
- 19 September, BoJ meeting
- 19 September, BoE meeting

Oct
- 20 October, Greek legislative election
- 21 October, Canadian federal election (date tbc)
- 24 October, ECB meeting
- 27 October, Argentina general election
- 30 October, FOMC meeting
- 31 October, BoJ meeting

Nov
- 7 November, BoE meeting

Dec
- 11 December, FOMC meeting
- 12 December, ECB meeting
- 19 December, BoJ meeting
- 19 December, BoE meeting



Ongoing monitoring

Central bank policy
- Statements by key central bank members
- Inflation-related data (e.g. CPI, wage growth, unemployment)

Economics
- Key economic data
- China economic policy

Geopolitics
- Supranational organizations (e.g. G7, G20, IMF)
- US-China relations (e.g. One China policy, South China Sea)
- Middle East
- Elections
- Sanctions (e.g. Russia, Iran)

EU politics
- Brexit negotiations
- Italian political events
- Turkey

Rising protectionism
- Negotiation on new and existing free trade agreements (e.g. NAFTA)
- New tariffs on goods and services (e.g. 45% tariff on Chinese goods)
- EU-UK negotiation

Impressum

Year Ahead 2019 – UBS House View
This report has been prepared by UBS AG, UBS Switzerland AG and UBS Financial Services Inc.. Please see the important disclaimer at the end of the document.

This report reflects the insights and perspective from the entire CIO team across the globe and demonstrates the intellectual leadership of UBS.

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