UBS House View

Monthly Base February 2019

Chief Investment Office GWM

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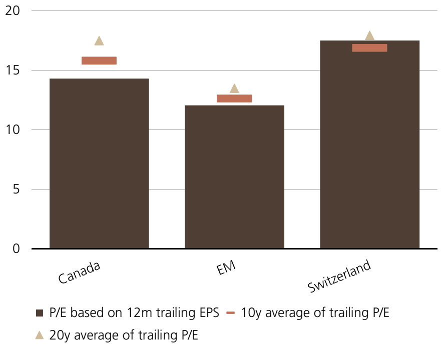
This document is a snapshot view. We update the tactical asset allocation as changes occur and resend it to subscribers. For all other forecasts and information, we advise you to check the Investment Views section in your E-Banking or in Quotes.

Published
Jan 24 2019

Financial Market Outlook – short term

Swiss equities look unattractively valued
Price-to-earnings ratio (P/E) based on 12-month trailing earnings per share (EPS)



Source: Thomson Reuters, UBS, as of 21 January 2019

EM sovereign bonds in USD spread has moved towards our target
Spread in bps

Source: Bloomberg, UBS, as of 21 January 2019

Global Tactical Asset Allocation

- **Asset allocation**
  After sharply repricing in December, risk assets have rebounded this year on the back of more dovish Fed rhetoric, the announcement of further China policy stimulus and signs of progress on US-China trade talks. While the economic backdrop has weakened, the strong US labor market and China stimulus are among factors that should help support growth in the months ahead. We keep our overweight position in global equities, but reduce risk exposure by closing our overweight position in emerging market sovereign debt. We also continue to manage downside risks through a put spread on the S&P 500.

- **Equities**
  Equity markets have shown signs of a recovery after reaching a trough in late December 2018. We remain constructive, based on our expectation for a stabilization in economic data after last year's deceleration in global growth momentum. We keep our preference for emerging market (EM) equities over Swiss equities, based on attractive valuations, the expectation for Chinese stimulus measures to start feeding into the macro data and potential further weakness in the dollar after the Fed's shift in tone. Furthermore, we stick to our Canada overweight vs. Australian equities. Valuations look attractive, in particular given the favourable earnings dynamics and our forecast for a rise in the oil price. Lastly, we add an overweight in Canadian equities over Swiss equities, also based on valuations grounds.

- **Bonds**
  We close our overweight on EM sovereign bonds in USD (EMBIGD) against high grade bonds. The near-term risk-return outlook has diminished as spreads have tightened towards our target level, while leading indicators suggest EM growth momentum has softened. We remain underweight 10-year Japanese government bonds versus JPY cash. We believe the Bank of Japan will allow yields to move further upwards as inflation picks up.

- **Foreign exchange**
  We add an overweight in the Norwegian krone against the CHF on the back of diverging economic momentum and central bank policies. We expect Norway to continue to hike rates, while the Swiss National Bank should wait for the ECB to eye a first hike. We are overweight the Canadian dollar against the Australian dollar. We expect higher oil prices and recovering Canadian growth to allow the Bank of Canada to hike rates. Australia faces many challenges including falling housing prices and curtailed bank lending, which should keep the Reserve Bank of Australia on hold until 2020. We see longer-term appreciation potential in the yen. We express this view by removing our currency hedge on Japanese equities, implementing a long yen position against the base currency in the portfolio since December.

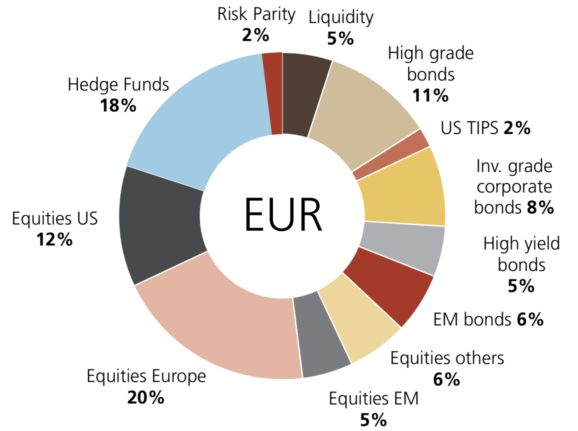
For further information please contact Head CIO Global Asset Allocation Andreas J Koester, andreas.koester@ubs.com or CIO asset class specialists Philipp Schöttler, philipp.schoettler@ubs.com or Carolina Corvalan, carolina.corvalan@ubs.com.

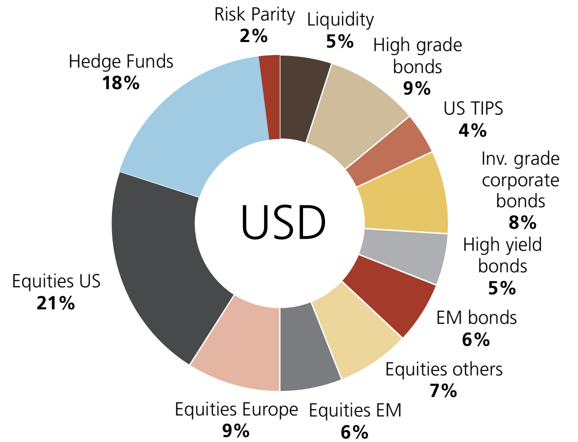
Cross-asset preferences

	We like...	We don't like...
Equities	Canadian equities (↗) Emerging market (EM) equities Global equities Global quality stocks EM value stocks "Buy-write" strategy on US equities US smart beta Some protection via US equity put options	Australian equities Swiss equities (↘)
Bonds	EM sovereign bonds in USD (↘) European leveraged loans	Developed market high grade bonds (↗) 10-year Japanese govt. bonds vs. JPY cash "Well-worn" bonds
Foreign exchange	Canadian dollar Norwegian krone (↗)	...Australian dollar ...Swiss franc (↘)
Hedge Funds	Navigating rising US rates with hedge funds	
Precious Metals & Commodities		

↗ Recent upgrades ↘ Recent downgrades

Model portfolios (EUR & USD)*



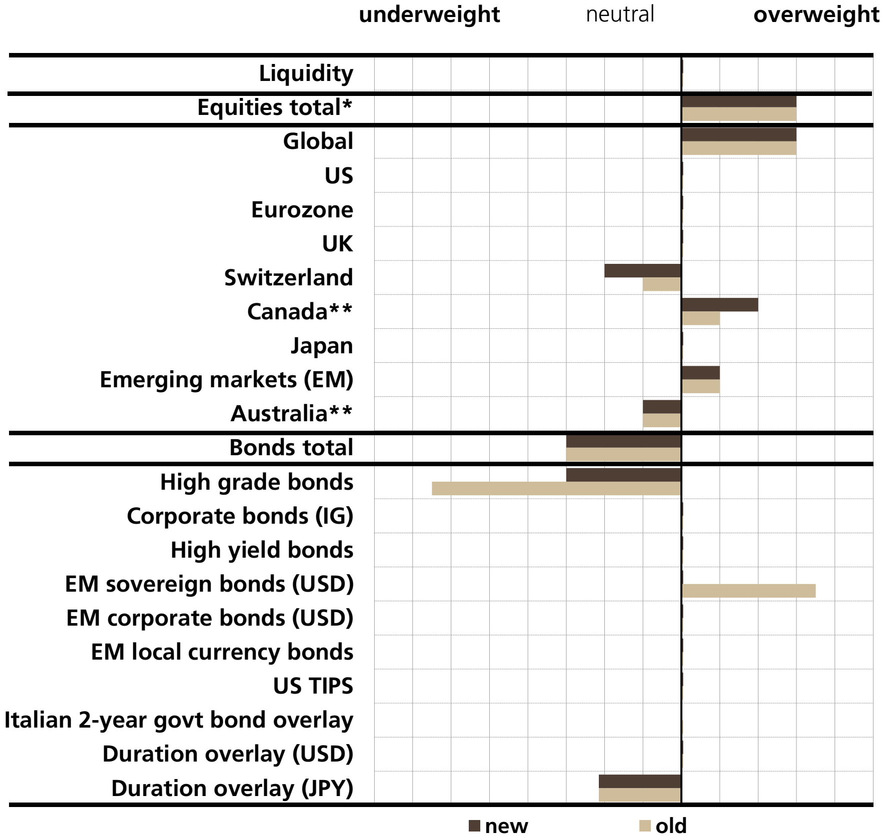


Source: UBS, as of 24 January 2019; * Additionally, the portfolios include an underweight in 10-year Japanese government bonds (via overlays) and put options on the S&P 500 index.

Note: Portfolio weightings are for a EUR model portfolio and a USD model portfolio, with a balanced risk profile (including TAA). We expect the EUR balanced portfolio (excluding TAA) to have an average total return of 2.8% p.a. and a volatility of 7.9% p.a. over the next seven years. We expect the USD balanced portfolio (excluding TAA) to have an average total return of 5.1% p.a. and a volatility of 7.9% p.a. over the next seven years.

Global tactical asset allocation

Tactical asset allocation deviations from benchmark

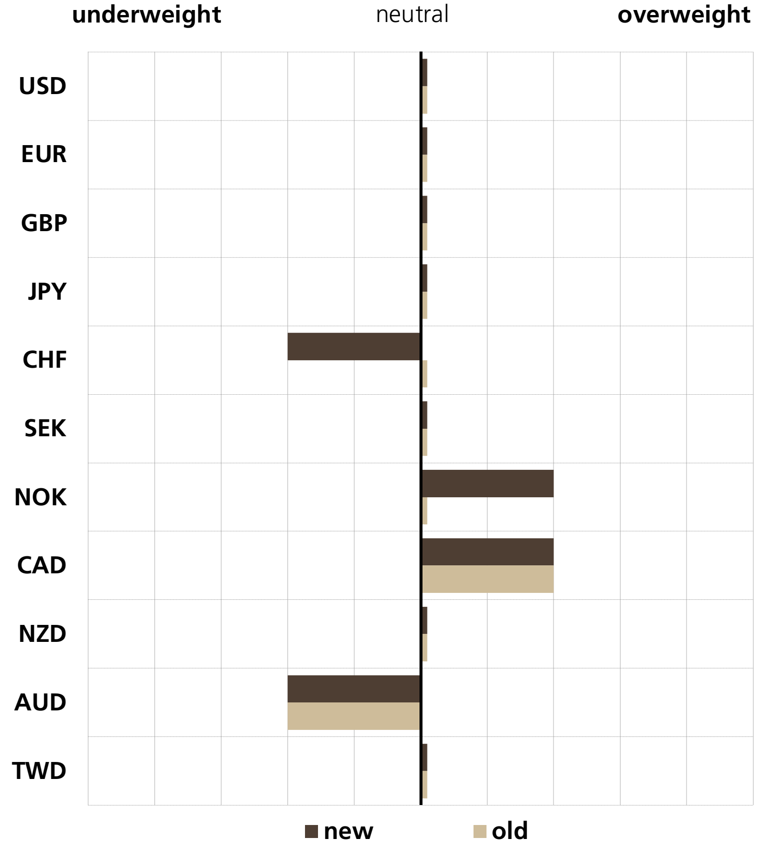


Source: UBS, as of 24 January 2019

Please note that the bar charts show total portfolio preferences, which can be interpreted as the recommended deviation from the relevant portfolio benchmark for any given asset class and sub-asset class.
*We are holding put options on the S&P 500 to partly protect the tactical asset allocation.
**Canada vs Australia equities applies to equity risk profile only.

Over a medium-term horizon (approx. 2-4 years) we hold the following positions, in addition to the above:
- Japanese equities on an FX-unhedged basis
- EM sovereign bonds (USD) vs. UK equities (2%)

Currency allocation



Source: UBS, as of 24 January 2019

CIO themes in focus

Equities

- **US smart beta**

  Certain stock characteristics (momentum, quality, small capitalization, risk-weighting, value, and yield) have been shown to deliver long-term investment outperformance relative to a market-capitalization-weighted index. Combining these characteristics, known in the industry as smart beta, makes the investment less cyclical and creates a "passive-plus" solution. Smart beta's compelling value proposition has resulted in considerable growth in assets. Smart beta ETF assets have risen to over USD 650bn and are growing by more than 30% a year.

- **Generate yield: "Buy-write" on US equities**

  An equity buy-write strategy involves the purchase of equities (the "buy" part) while systematically selling (or "writing") call options that cover the position, typically on a monthly schedule. In exchange for giving a counterparty the right, but not the obligation, to buy the underlying asset at a predetermined price, the buy-writer receives a premium. Over an economic cycle, equity buy-write strategies generate attractive risk-adjusted returns as they capture both the equity and volatility risk premium. They are most appealing when equity returns moderate and market momentum decreases and, historically, perform strongly during periods of rising rates.

- **Global quality matters**

  The quality factor aims to reflect the performance of companies with durable business models and sustainable competitive advantages. It therefore targets companies with a high return on equity, stable earnings, and low financial leverage. In the advanced stage of the business cycle, when monetary policy is less accommodative and volatility rises, quality matters. As trade uncertainties remain high, a global sector-neutral quality strategy can also offer added downside protection in a relative context.

- **Finding value in EM**

  Value stocks have been emerging market (EM) underdogs in recent years. However, we think the reversal seen since July 2018, triggered by a correction in both tech and consumer sectors is here to stay. EM value has now outperformed growth by 7% year-to-date 2018. We reiterate our preference for EM Value stocks over EM growth stocks as valuation and earnings momentum remain more attractive for the value heavyweight sectors (financials, energy, materials). Key drivers are a pickup in the EM growth differential over developed markets and a recovery in commodity prices. Risks to this theme include tighter global liquidity conditions derailing the EM recovery, continued weakness in commodity prices and a rally in the IT sector.

Bonds

- **Replacing well-worn bonds**

  Risk-free yields in some major developed markets are near or below zero. Even if rates stay unchanged, many short- to medium-term bonds would deliver negative total returns. We think investors can preserve wealth by taking profits on assets that will deliver negative returns (exceeding switching-out costs) in most likely scenarios. More attractive alternatives can be found on CIO's bond recommendation lists.

- **Opportunities in European leveraged loans**

  Financial market volatility has risen in 2018, while attractive fixed income investments in Europe remain hard to find. We think European leveraged loans offer an appealing risk-reward profile due to their attractive yield and generally low volatility, and our outlook for low default rates. European leveraged loans are offering a yield of 4.6%, which compares favorably with other bond alternatives. We expect 12-month total returns of 4–5% in EUR and 7–8% hedged into USD. European loans outperformed most other asset classes in 2018 with total returns of +1.3%, despite the late-year correction, and have stabilized so far in 2019.

CIO themes in focus

Alternative investments

- **Navigating rising US rates with hedge funds**

  The US Federal Reserve has started to hike interest rates. Historically, most hedge fund strategies have been resilient to rising rates, while high grade bonds have performed poorly. Investors looking for an alternative to their high grade bond exposure should consider a diversified hedge fund portfolio characterized by low directional exposure to both fixed income and equities.

This selection of themes is a subset of a larger theme universe. It represents the highest conviction themes of the UBS Chief Investment Office GWM, taking into account the current market environment and risk-return characteristics.

CIO longer term investment themes in focus

Equities

- **Space**

  The sharp decline in launch costs is lowering entry barriers to space. We forecast the space economy will likely grow from USD 340bn currently to almost USD 1trn in the next couple of decades, catalyzed by sustained capital investment by new-economy billionaires. Investment exposure at this early stage is best gained via existing listed companies in the aerospace, satellite and communications segments. New space start-ups may offer investment opportunities in private markets.
- **Medical devices**

  The world's aging population and the growth of the over-65 age group will create more opportunities for companies selling medical products and devices. Other drivers of the medical device industry include better penetration in emerging markets due to improved infrastructure, new innovative treatments, increased affordability due to rising per-capita GDP, and a growing prevalence of "lifestyle diseases" like obesity due to urbanization. We expect sustainable mid-single-digit revenue growth.
- **EM tourism**

  Urbanization and income growth are driving demand growth for emerging market tourism and global aviation infrastructure. Already, the number of emerging market air passengers carried globally exceeds that of developed markets. Airbus forecasts that two-thirds of new plane orders will come from emerging markets in the next 20 years. The growth of EM tourism is further supported by government policy, particularly economic diversification away from commodity exports and rising visa openness to draw visitors and attract foreign-currency receipts.
- **Fintech**

  Driven by rapid urbanization, strong demand from millennials, and favorable regulations, the global fintech industry is at an inflection point and set to drive a major digital transformation in the financial services industry. We expect global fintech revenues to grow from USD 120bn in 2017 to USD 265bn in 2025, implying an average annual growth rate that's about three times faster than the broader financial sector's.
- **Silver spending**

  We expect the spending power of older demographics to become increasingly important in the years to come as the weighting of the older population rises. These "silver spenders" tend to allocate more of their disposable income to leisure and tourism (particularly cruises), consumer personal care (specifically anti-aging products), healthcare services, retirement housing and financial planning services. These markets are estimated to grow by 5–10%, compared with the less than 2% growth in consumer spending in G7 nations.

This selection of themes is a subset of a larger theme universe. It represents the highest conviction themes of the UBS Chief Investment Office GWM, taking into account the current market environment and risk-return characteristics. The Longer Term Investment (LTI) theme series focuses on inevitable global trends, such as population growth, aging, and urbanization, that create a variety of opportunities, with certain companies and subsectors experiencing a higher-than-GDP rate of revenue growth. Here, we include a subset of a larger universe of LTI themes expected to offer good entry points for theme-oriented investors in the coming months, and highlight our preference for a diversified approach to themes.

Key investment risks

Selected Scenarios		Scenario Description	Expected market performance for select asset classes
Base case	**Positive outlook with increased volatility**	Global economic performance remains solid, but ongoing trade tensions and uncertainty about Eurozone growth keep the volatility high.	**US equities** +4–8% as valuation multiples recover from the growth scare in 4Q18. Growth is decelerating but is not rolling over. **Eurozone equities** around -5 to +10% amid political uncertainty surrounding Italy, Brexit and trade conflict **EURUSD** between 1.15 and 1.20 as monetary policy is being normalized
Key upside scenarios	**Trade: A comprehensive deal with rollback of existing tariffs**	With China ready to make clear concessions to the US, both countries strike a new deal that reduces existing trade barriers	**US equities** +10–15% as earnings estimates rise to the mid $170s on improving global growth and the PE multiple expands more than 10% **Chinese equities** +10-15% due to a strong recovery on risk sentiment and better than expected fundamentals **USD** down to approximately EURUSD 1.20–1.25
	China: Stable GDP growth	Chinese GDP growth remains in a 6.6-6.8% range as the current account balance goes back above USD 100bn.	**Chinese equities** +15–20% due to a recovery on valuation as growth beats consensus expectations **EMBIGD** +4–5% as spreads tighten to around 310bps due to improving EM growth prospects **CNY** up to USDCNY 6.50 as strong Chinese growth supports the domestic equity market, preventing outflows and supporting inflows of capital
Key downside scenarios	**Trade: Further US sanctions**	Further sanctions are implemented, notably an increase of tariffs on USD 200bn of Chinese goods from 10% to 25%, tariffs on remaining Chinese imports, and tariffs on car imports.	**US equities** -4–8% as earnings estimates and valuations fall modestly **Chinese equities** -20–25% as sentiment tanks further with worse than expected economic consequences **USD** up to around EURUSD 1.10 as US tariffs are supporting the USD
	Fed ends the business cycle sooner	As US inflation rises rapidly, the Fed is forced to hike rates at each meeting. This leads to a flat or inverted US Treasury yield curve towards mid-2019, followed by an equity bear market. A US recession starts early 2020.	**US equities** -10–15% as valuations fall 10% and earnings are flat in 2019 **US high yield** -7–9% US high yields spreads widen towards recession levels, while mid- to longer-term US Treasury yields fall **USD** - EURUSD falls to or below 1.10 as the USD strengthens due to contractionary monetary policy

Expected total returns over a 6-month horizon
Note: Upside and downside scenarios are possible events outside of CIO's base case expectations.
For futher information please contact CIO strategist Dirk Effenberger, dirk.effenberger@ubs.com

Expected trend in asset class

+50% +25% 0% -25% -50%

Source: UBS, as of January 2019

Key financial market driver 1 - *Central bank policy*

Key points

- The US Federal Reserve has signaled a pause in the process of raising interest rates. However the indications are that further interest rate increases will still take place. The Fed had previously signaled a review of policy, and there have been clearer suggestions that this will include the pace of reversing quantitative policy.
- The European Central Bank (ECB) has concluded the aggressive phase of bond buying. There are no signs of a move to raise interest rates while ECB President Draghi remains in office (until September of this year).
- The Swiss National Bank is unlikely to raise interest rates in the near term, given the increased global uncertainty (and the potential for safe-haven flows). The Bank of England's policy remains contingent on the nature of the UK-EU separation.

CIO view (Probability: 70%*) — **Policies tighten gradually**

- The economic consensus, and the US Federal Reserve's own signals, suggest further rate hikes in the US (with at least one this year). Financial markets do not appear to be hearing that message. It is not unusual for markets to get the Fed wrong - the Fed serves the economy as a whole, not the small part of the economy represented by equities or corporate bonds. However the Fed does not want to cause financial disorder (as that has economic consequences).
- The US central bank is likely to raise rates when growth is at or above 2%, when the core PCE deflator measure is at or above 2%, and when the market probability of a rate increase exceeds 50%. The current government shutdown suggests that those three conditions are unlikely to be met in the short term, but they could be met this year.
- Market expectations for a rate increase in the Euro area suggest that such a move will come after ECB President Draghi leaves. Who succeeds Draghi may not be that important to the near-term policy outlook, but could shape the longer-term bias of policy.
- Central banks are still more minded to tighten than to ease as a rule (Australia and Japan are perhaps exceptions). But there has been a shift in tone in recent weeks, as political risks have created some economic disruption. Central banks seem keen not to amplify those risks by adding another level of uncertainty.
- The tightening of central bank policy represents a shift from past cycles. This time, central banks have no desire to temper economic growth or inflation; the aim is to maintain them around current levels. Past episodes of policy tightening had deliberately sought to reduce company pricing power and inflation.

↗ **Positive scenario (Probability: 20%*)** — **Policy easing as macro backdrop worsens**

- Political policy errors threaten growth either through more aggressive trade disruption, or weaker US or European growth. Central banks respond to the changing economic outlook with a halt to policy tightening, followed by appropriate easing.

↘ **Negative scenario (Probability: 10%*)** — **Central banks seek to reduce pricing power as macro risks fade**

- Tighter labour markets move from squeezing profit margins to causing firms to raise prices more significantly. Trade taxes are passed on more comprehensively than has been the case so far.

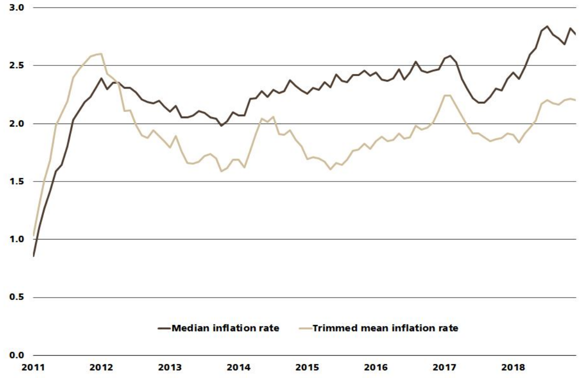
*Scenario probabilities are based on qualitative assessment

Key dates

Feb 7	Bank of England meeting
Feb 20	US Federal Reserve FOMC minutes published

US inflation - not showing weakness

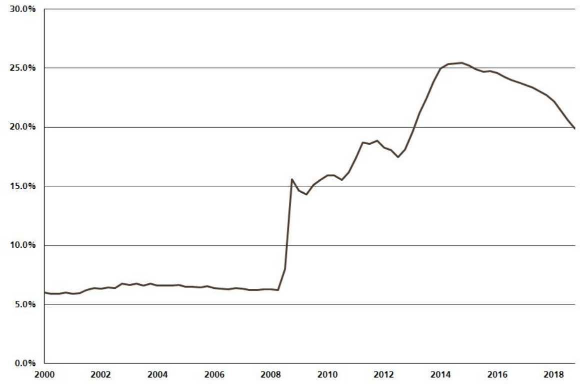
Median and trimmed mean inflation rates show most prices continue to rise in the US



Source: Haver, UBS, as of 19 January 2019

US Federal Reserve balance sheet continues to decline

Characterising this as a loss of liquidity is not necessarily accurate. The Fed is reacting to falling liquidity preference in the US economy



Source: UBS calculations as of 19 January 2019. Q4 2018 GDP is a forecast

Key financial market driver 2 - *Political risks*

Key points

- The US government shutdown has limited macroeconomic impact (while being very painful for those directly affected). Investors are taking this as a signal of what a gridlocked US government may look like over the next two years, and so are inclined to react to the larger potential economic risks.
- European political risk continues to focus on the UK-EU divorce process, where approval of the Withdrawal Agreement is struggling with the complications of UK parliamentary arithmetic. Italy's budget has faded as an immediate economic concern. French protests offer some limited disruption to economic growth in the near term.
- Financial markets are more sensitive than the wider economy to trade risks. So far US tariffs appear to have been relatively simple to evade. The longer tariffs are in place, and the larger the number of goods they apply to, the more likely it is they are passed onto US consumers. Realization of the market and economic damage increases the chance of a calming of some of the current tensions.

CIO view (Probability: 70%*)

- Markets appear to view the current US government shutdown as a foretaste of future policy gridlock. While the economic impact of the current shutdown is limited, the damage is cumulative the longer the disruption lasts. There is a signal to investors for the health of future political negotiations around the debt ceiling (second quarter) and the September budget.
- US tariffs to-date have not generally impacted the overall volume of global trade, nor China's trade surplus with the US. Imports may have been accelerated to beat tariff increases. Companies do seem to be finding ways of evading tariffs. Consumers have not (by and large) felt the effects of the last round of increases, as many of the goods purchased into the end of 2018 were imported before the tariffs took effect. The effects may start to become more visible. The market damage from taxing trade (which can be thought of as being primarily a tax on equities) has been noted politically and may encourage a limited trade agreement to calm some of the current China-US tensions.
- Our base case is some negotiated separation between the UK and the EU will be agreed upon. However, the difficulty securing UK parliamentary approval adds uncertainty and any form of agreement by 29 March looks increasingly unlikely.
- Nationalist and anti-politics have been gaining ground in some areas of Europe, and this will remain a periodic focus for markets (as it makes policy less predictable). French protests underscore the volatility often associated with single-issue politics.

↗ **Positive scenario (Probability: 10%*)**

- Better labor market conditions for low-skilled workers lead to faster wage hikes; this eases income and consumption inequality. The costs of trade protection are made more apparent to US voters through the actions of corporations, and the US retreats from its isolationist agenda.

↘ **Negative scenario (Probability: 20%*)**

- Nationalist tendencies are encouraged by single-issue politics and social media. Traditional party structures fail to address the demands of large sections of the electorate. Political outcomes are increasingly unpredictable as opinion polls offer even less guidance. Trade protectionism escalates. Lower-income groups' standards of living are hurt by populist policies and rising prices, fueling further demands for radical and unpredictable change.

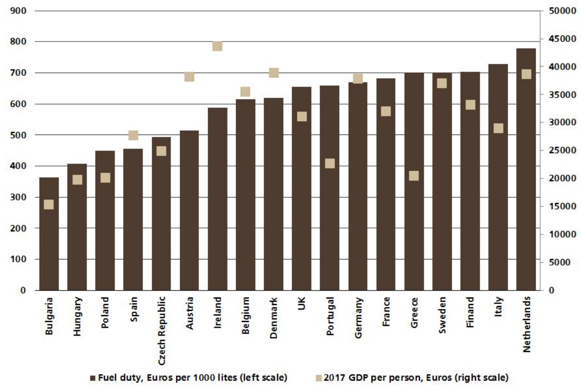
*Scenario probabilities are based on qualitative assessment.

Key dates

Feb 17	Release of results of US Section 232 investigation on car imports

Selected European fuel duties, compared to living standards

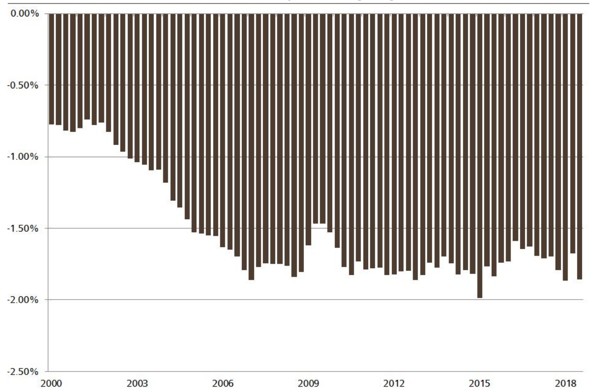
France's "gilet jaune" protest fuel taxes, but these are similar to those of the rest of Europe. Triggers for single-issue politics are hard to predict



Source: European Commission, UBS, as of 19 January 2019

US China trade balance as % of US GDP (using US data for trade)

Cutting income taxes for consumers that like to import encourages imports. Taxing trade makes companies less efficient, without necessarily changing trade



Source: Haver, UBS as of 19 January 2019

Key financial market driver 3 - *Deceleration but no contraction*

Key points

- Economic and corporate profit growth is decelerating
- However, leading indicators remain supportive and a contraction looks unlikely
- We expect mid-single-digit profit growth in 2019

CIO view (Probability: 60%*) **Deceleration but no contraction**

- US earnings growth is decelerating as the one-time boost from a lower tax rate rolls off and economic growth slows. Still a decline in profits looks unlikely. Leading indicators such as bank lending standards, capital spending intentions, and unemployment claims (see bottom chart) remain supportive.
- Final 2018 S&P 500 EPS will likely come in at USD 164 (23% growth). Growth should slow in 2019 as the benefit of one-time items such as tax reform, higher energy earnings, and incremental share buybacks falls off.
- In addition, slower global economic growth this year, limited growth in energy sector profits due to the plunge in oil prices, and a slowdown in smartphones and semiconductors will also weigh on the outlook. Our 2019 EPS estimate is USD 171 (4.5% growth).
- The fourth-quarter earnings season is underway and results so far have been mixed, although better than feared. While there have been some high profile earnings warnings in the smartphone and transport segments, we think most of the difficulties stem from company-specific issues and have less to do with macro-economic weakness. In addition, there have been some positive pre-announcements in other segments of the market such as wireless telecom, medical devices, and life sciences. While management teams will likely acknowledge the financial market volatility, we think most companies will offer guidance that suggests moderate profit growth in 2019.
- Fears that high profit margins will decline in the near term appear overblown. Excluding the tech sector, we believe margins are not excessive. The tech sector's high margins are supported by companies with dominant market shares. Other structural factors, such as industry consolidation and a secular decline in tax rates, support higher-than-average profit margins. In addition, margins typically only decline in a recession. Finally, the prospect of higher wages is unlikely to dent the outlook. Labor cost inflation has virtually no correlation with earnings growth as higher consumer income is usually recycled into faster consumer spending.

↗ **Positive scenario (Probability: 20%*)** **Fiscal policy boosts earnings more than expected**

- Corporate tax reform and increased government spending generate even faster-than-expected profit growth. Deregulation further boosts financial sector earnings. Investment spending picks up.

↘ **Negative scenario (Probability: 20%*)** **Downturn in sentiment**

- Trade and geopolitical tensions flare up, depressing business and consumer sentiment. Wage pressures, without improving consumer and business demand, crimp profit margins and earnings growth rates. Declines in long-term interest rates pressure financial sector earnings.

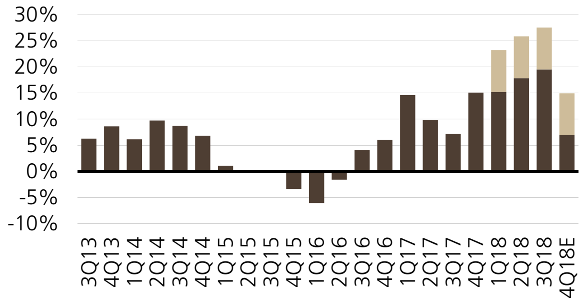
*Scenario probabilities are based on qualitative assessment.

Key dates

Jan 28	Peak of fourth-quarter earnings season

Earnings growth is decelerating on tougher comparisons

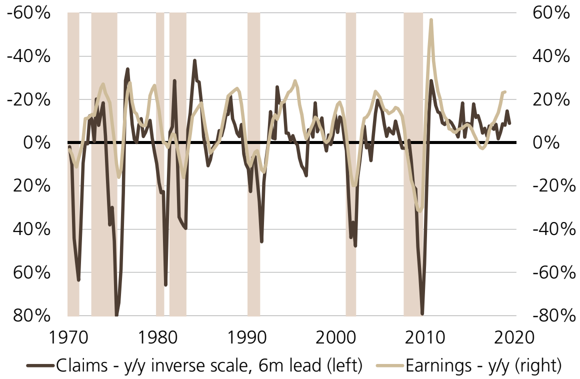
S&P 500 EPS growth; tan represents boost from lower tax rate



Source: FactSet, UBS, as of 16 January 2019

Falling claims for unemployment insurance bodes well for future profit growth

Change in initial claims for unemployment insurance and S&P 500 EPS, with recession periods



Source: Bloomberg, UBS, as of 16 January 2019

Global economic outlook - *Summary*

Key points

- Global growth is expected to come in around trend in 2019, having been a little above trend in 2018. Latin America may see slightly stronger growth, but in other regions growth normalization should take place.
- The risk of a global recession in 2019 remains very low. The normal conditions for a recession (economic overheating, or significant policy error) are not in evidence. Political risk may drive a more significant slowdown in growth, however.
- Domestic demand remains relatively good in most economies. Global trade was stable as a share of world GDP in 2018. In the absence of a major trade conflict or a sharp drop in investment spending, global trade should remain stable.

CIO view (Probability: 65%*) — **Global growth slightly slower, around trend**

- Global growth remains relatively well supported. Labor market strength continues in most major economies, giving consumers better household income (via increased employment, increased wages, or both). However, risks to growth have risen given ongoing political uncertainty. This may affect both economic reality (through slowing investment, or restrictions on consumers), and reported economic sentiment (where consumers and companies report more negative sentiment, but do not translate that into action).
- Trade tensions have so far served as a relative shock more than an absolute economic shock. Certain sectors, and larger (generally) listed companies have been affected as those are most engaged in international trade. Much of the global economy has been unaffected. Global trade is set to be stable as a share of global GDP in 2018, and if domestic demand patterns are unaffected by additional trade disputes the plateauing of trade to GDP should continue in 2019.
- Underlying inflation trends remain relatively benign, although the stronger labor markets should be monitored. The first quarter is often an important period for price setting, especially in the United States, so any evidence of stronger pricing power in the near term should be considered significant.

↗ **Positive scenario (Probability: 15%*)** — **Growth exceeds expectations**

- Tax rebates and a calming of political risks mean that US growth slows less than expected. European growth benefits from a less restrictive fiscal policy (France and Italy in particular) combined with ongoing improvements in labor markets.
- Chinese domestic stimulus supports their economy, with some spillover effects into Australia and the rest of South East Asia.

↘ **Negative scenario (Probability: 20%*)** — **Political damage to growth**

- The US government shutdown persists, creating a modest drag on growth and deteriorating expectations about future government action. Trade tensions do not fade, but instead widen to create uncertainty in Europe and around the alternative to NAFTA. The UK exits the EU without a deal, causing some damage to the European economy.
- Investment spending is affected by the uncertainty, which disproportionately affects the outlook for trade (as investment demand is an important part of international trade). This then spills over into a moderately weaker labor market.

*Scenario probabilities are based on qualitative assessment.

Key dates

Feb 1	US employment report
Feb 14	German Q4 GDP

Growth returns to trend-like rates

UBS estimates and forecasts

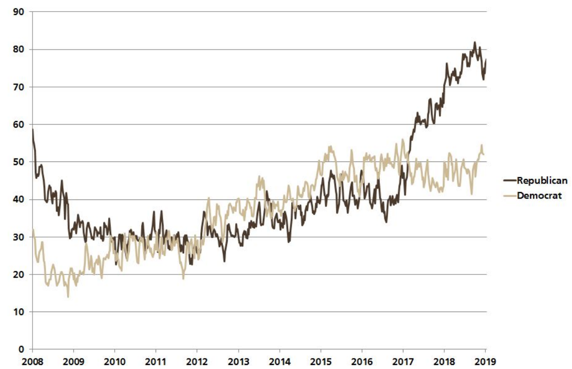
		Real GDP growth in %					Inflation in %				
		2016	2017	2018F	2019F	2020F	2016	2017	2018F	2019F	2020F
Americas	US	1.6	2.2	2.9	2.5	2.0	1.3	2.1	2.4	1.4	2.2
	Canada	1.4	3.0	2.1	2.5	2.3	1.4	1.6	2.3	2.2	2.1
	Brazil	-3.5	1.0	1.3	3.0	2.5	8.7	3.4	3.7	4.0	4.3
Asia/Pacific	Japan	0.6	1.9	0.8	1.7	0.9	-0.1	0.5	1.0	1.7	3.0
	Australia	2.8	2.4	3.0	2.7	2.5	1.3	1.9	1.9	2.0	2.1
	China	6.7	6.9	6.5	6.1	6.0	2.0	1.6	2.2	2.0	1.8
	India	7.1	6.7	7.3	7.3	7.4	4.5	3.6	3.5	4.0	4.3
Europe	Eurozone	1.9	2.5	1.9	1.6	1.5	0.2	1.5	1.7	1.3	1.6
	Germany	2.2	2.5	1.5	1.6	1.5	0.4	1.7	1.9	1.2	1.7
	France	1.1	2.3	1.6	1.6	1.6	0.3	1.2	2.1	1.2	1.4
	Italy	1.3	1.6	1.0	1.0	0.9	0.0	1.3	1.2	0.7	1.0
	Spain	3.2	3.0	2.5	2.2	2.0	-0.3	2.0	1.7	0.8	1.6
	UK	1.8	1.7	1.2	1.8	1.3	0.7	2.7	2.5	2.1	2.1
	Switzerland	1.6	1.7	2.6	1.5	1.7	-0.4	0.5	0.9	0.8	1.0
	Russia	0.3	1.6	1.6	1.5	2.1	7.0	3.7	2.9	5.5	3.9
World		3.2	3.9	3.8	3.7	3.7	2.7	2.7	3.0	2.9	2.9

Source: UBS, as of 24 January 2019

Forecasts and estimates are current only as of the date of this publication, and may change without notice.

Political distinction in sentiment data

US Bloomberg consumer sentiment index broken down by political affiilation of respondent



Source: Bloomberg, UBS, as of 19 January 2019

US economy - *Moderate growth in the US*

Key points

- Economic growth should slow over the next 12 months as fiscal and monetary stimulus fades.
- Core inflation should remain near the Fed's 2% target.
- Monetary policy should be at a neutral setting by the end of 2019.

CIO view (Probability: 60%*) **Moderate expansion**

- The strong labor market and income tax cuts should support robust consumer spending.
- Business investment should continue to increase, encouraged by strong profits and labor shortages, although trade disputes will likely act as a constraint.
- Manufacturing output should rise at a moderate pace.
- Recent housing data has been weak, suggesting that higher interest rates are restraining growth. However, demand for housing should be supported by the strong labor market, limiting downside risk.
- Tax cuts and increased government spending are providing a substantial stimulus to growth that will start to fade in 2019. Deregulation should provide some economic benefit over time.
- Core inflation, which excludes food and energy prices, should continue to run close to the Fed's 2% target.
- The Fed is aiming for a neutral monetary policy stance. In our base case, we expect one 25 basis point rate hike over the course of 2019.
- Risks to the recovery may increase toward the end of 2019 as fiscal and monetary policy offer less support.

↗ **Positive scenario (Probability: 15%*)** **Strong expansion**

- US real GDP grows above 3%, propelled by an accommodative monetary policy, loose fiscal policy, strong household spending, and breakthroughs in trade negotiations. Inflation overshoots the Fed's 2% target, potentially leading the central bank to raise rates beyond neutral.

↘ **Negative scenario (Probability: 25%*)** **Growth recession**

- US growth stumbles. Trade disputes, political uncertainty, and tighter financial conditions weigh on business investment and consumer spending. The Fed stays on hold.

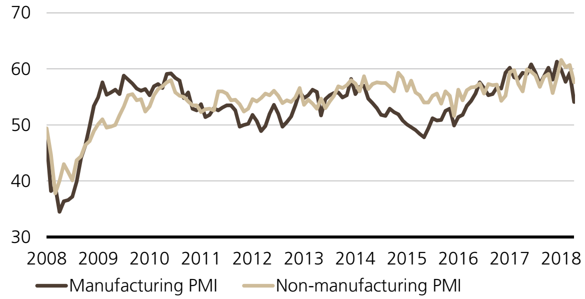
*Scenario probabilities are based on qualitative assessment.

Key dates

Jan 30	GDP for 4Q18
Jan 30	FOMC rate decision
Jan 31	Personal income and spending, PCE deflator for December
Feb 1	Labor report for January

PMIs have fallen from their highs

Manufacturing and non-manufacturing PMI

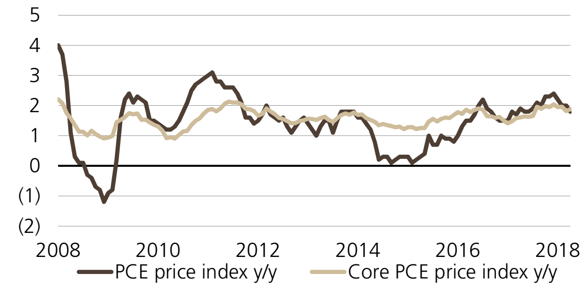


Source: Bloomberg, UBS, as of 14 January 2019

PMI = Purchasing Manager Index

Inflation is near the Fed's 2% target

PCE and core PCE inflation rate, in %



Source: Bloomberg, UBS, as of 14 January 2019

PCE = Personal Consumption Expenditures

Eurozone economy - *Growth to normalize after soft patch*

Key points

- We expect economic growth to normalize after the lull in 2H 2018.
- Inflation is set to move sideways
- We expect the ECB to start raising rates in December 2019.

CIO view (Probability: 60%*) — **Growth to stabilize at solid levels**

- Following the dent in car production in the summer because of new emission standards, activity is set to normalize in the first half of 2019, supported by lower oil prices and some fiscal stimulus. The ECB remains in wait-and-see mode, as the labor market continues to recover and until key risks fade. We think the central bank may start raising rates in December 2019 and is set to offer banks two- or three-year LTROs by June 2019.
- In Germany, fundamentals such as consumer confidence, wage increases and construction remain robust, mitigating the impact from global protectionism. In France, President Emmanuel Macron's reforms and fiscal stimulus should start to help stabilize GDP growth.
- Growth in Italy should stabilize following the budget agreement with the European Commission. Spain is still growing strongly, but the momentum is likely to continue to normalize.

↗ **Positive scenario (Probability: 20%*)** — **Better-than-expected growth**

- The global economy accelerates again and the euro weakens. Eurozone loan demand and the economy recover faster than envisaged. Political risks fade.

↘ **Negative scenario (Probability: 20%*)** — **Disinflationary setback**

- The Eurozone suffers a disinflationary setback as markets lose faith in Italy's debt sustainability, trade tensions escalate sharply, Brexit talks fail, or the Chinese economy suffers a severe downturn.

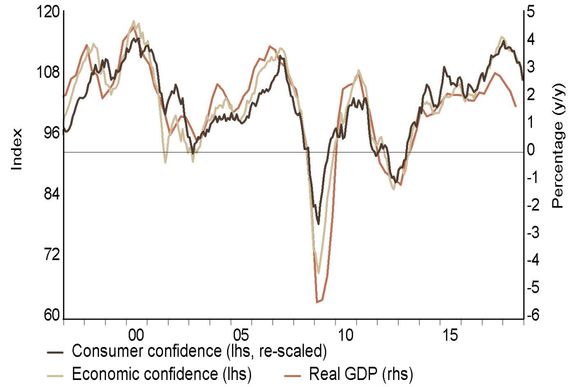
*Scenario probabilities are based on qualitative assessment.

Key dates

Jan 31	Unemployment for December
Jan 31	GDP estimate for fourth quarter
Feb 1	Inflation estimate for January

Eurozone growth consolidating in 2018

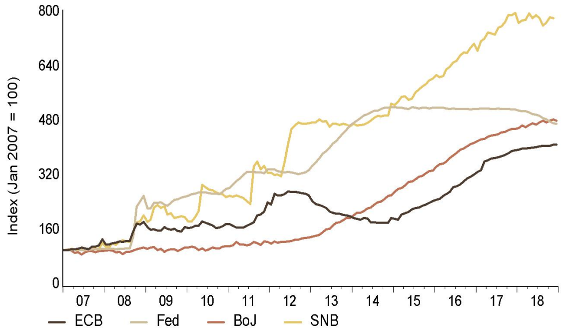
Business and consumer surveys



Source: Haver Analytics, UBS, as of December 2018

ECB balance sheet topping out

Total assets in national currency (index: 2007=100)



Source: Haver, UBS, as of December 2018 (SNB data as of November 2018)

Chinese economy - *Growth set to moderate*

Key points
- 2019 GDP growth to continue orderly deceleration
- 2019 monetary and fiscal policy will remain supportive of growth
- Sino-US trade tension will remain a key risk

CIO view (Probability: 80%*) **Growth set to moderate**
- Sino-US trade tensions and domestic headwinds will likely dampen 2019 GDP growth. We expect an orderly deceleration of real GDP growth to 6.1% y/y in 2019 from 6.6% y/y in 2018.
- 2019 CPI inflation is expected to ease to 1.8% y/y from 2.1% y/y on lower food and energy inflation amid weakening demand. We see low single-digit PPI inflation in 2019, with some months potentially seeing deflation.
- We think 2019's monetary policy will be accommodative, while fiscal policy is expected to remain proactive. We expect a further 100-200bps of Required Reserve Ratio (RRR) cuts and enhanced liquidity by way of various lending facilities. Fiscal policy should remain proactive with a focus on supporting infrastructure project investment as well as tax and fee cuts. We expect a mild increase in leverage. Credit growth is likely to stabilize at around 10% y/y compared with 9.8% y/y in 2018.
- Investment will be the key driver of growth supported by infrastructure investment backed by local governments. Retail sales are expected to remain largely resilient given personal income tax cuts and consumer subsidies.
- Sino-US trade tensions remains a key risk. The Sino-US relationship is entering a "new paradigm" with long-lasting cycles of talk-fight-talk. The trade spat is likely to splinter supply chains, with the US's benefiting from core high technology and innovation output and China's from its large, skilled, labor force, superior infrastructure and high degree of industrialization. The rest of world will leverage both, benefiting their own interests.

↗ **Positive scenario (Probability: 5%*)** **Growth acceleration**
- Annual GDP growth accelerates above 6.8% on easing trade tensions and cyclical global growth. Aggregate debt-to-GDP ratio stabilizes. Annual current account surplus increases over USD 100bn.

↘ **Negative scenario (Probability: 15%*)** **Escalating China-US trade tension**
- The US makes good on its threat to impose investment restrictions and tariffs on most Chinese products, introducing a sweeping 25% tariff on some USD 500bn of Chinese imports before 2020. In 2019, the Chinese economy experiences a sharp slowdown in growth (5% real GDP growth for two quarters), and its current account deteriorates rapidly and turns into a deficit. The USDCNY exchange rate slides to 7.5 or even weaker within a quarter, China's FX reserves fall dramatically, and authorities tighten capital controls. Asian and emerging market assets sell off.

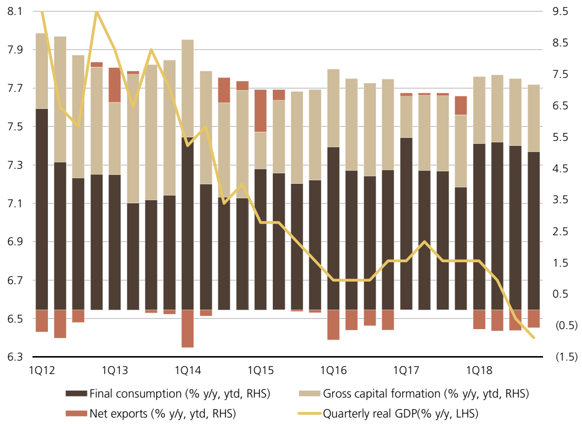
* Scenario probabilities are based on qualitative assessments.

Key dates

Jan 31	Manufacturing and non-manufacturing PMI for January
Feb 15	CPI and PPI inflation for January
Feb 28	Manufacturing and non-manufacturing PMI for February

2019 GDP growth to continue orderly deceleration

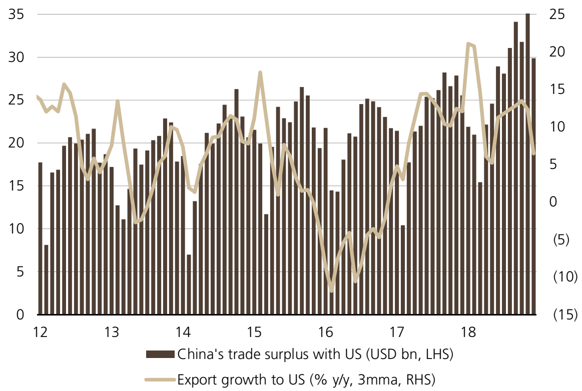
Year-to-date quarterly GDP growth



Source: CEIC, UBS, as of January 2019

China's export growth to the US slowed notably in December

Sino-US trade balance and China's export growth to US



Source: CEIC, UBS, as of December 2018

Swiss economy - *Cloudy outlook*

Key points

- The Swiss economy contracted by 0.2% in 3Q18. GDP numbers showed weakness across-the-board. After several quarters of above long-term average growth we see the slight drop in 3Q more as a breather rather then the start of major weakness.
- Nonetheless, the outlook for the Swiss economy is clouded. Global political risks, a stronger Swiss franc, slower growth in the Eurozone and the lack of catch-up potential may slow GDP growth in 2019 to 1.5%.
- Given these risks, we expect the first Swiss National Bank (SNB) rate hike to be in 4Q19 after the first expected increase by the European Central Bank (ECB) in its target rate.

CIO view (Probability: 60%*) **Robust recovery**

- Swiss GDP fell by 0.2% qoq in 3Q18 but advanced by 2.2% on a yoy basis. Net exports and equipment investments were a drag on economic growth. Consumer demand also stagnated and failed to support the economy.
- The contraction of 3Q GDP may exaggerate the Swiss economy's slowdown. Nonetheless, the weak print is a clear indication that Swiss growth momentum has peaked. On a positive note the Swiss labor market has improved substantially in recent quarters.
- The outlook for the Swiss economy remains clouded. Political risks, the appreciation of the Swiss franc and slower-than-expected growth in the Eurozone are likely to slow Swiss GDP growth in 2019. We forecast GDP to grow by 1.5% in 2019 after 2.6% in 2018.
- The Swiss manufacturing PMI increased slightly in December (Nov: 57.7 to Dec: 57.8), and remains above its long-term average of 55 points.
- Inflation slowed to 0.7% yoy in December, driven by lower oil prices. The average annual inflation rose to 0.9% in 2018 from 0.5% in 2017.
- With risks having increased notably in recent months, we don't see a first rate hike by the SNB before 4Q19 after the first expected increase by the European Central Bank (ECB) in its target rate. We would only expect FX interventions from the SNB if the EURCHF exchange rate were to fall below the 1.10 mark.

↗ **Positive scenario (Probability: 10%*)** **Eurozone strength and weaker Swiss franc boost Swiss growth**

- A further drop in Eurozone unemployment leads to a rebound in Europe and shores up domestic demand, which in turn supports Swiss exports.

↘ **Negative scenario (Probability: 30%*)** **Trade disruption hurts Swiss growth**

- More protectionist measures by the Trump administration lead to a global downturn, which would hurt Swiss exports. Increased uncertainty with respect to Italian politics and emerging markets could lead to an appreciation of the franc.

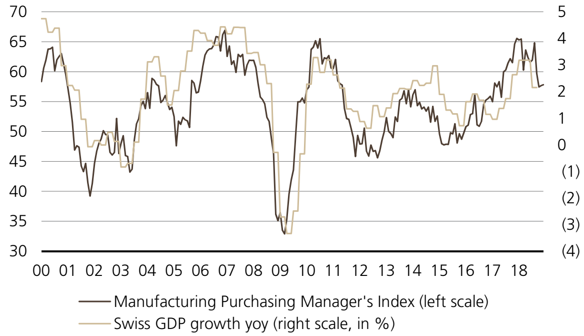
* Scenario probabilities are based on qualitative assessment.

Key dates

Feb 1	Seco Consumer Confidence (Jan) and PMI (Jan)
Feb 11	CPI (Jan)
Feb 19	Trade Balance (Jan)

Leading indicator suggest cooling economy

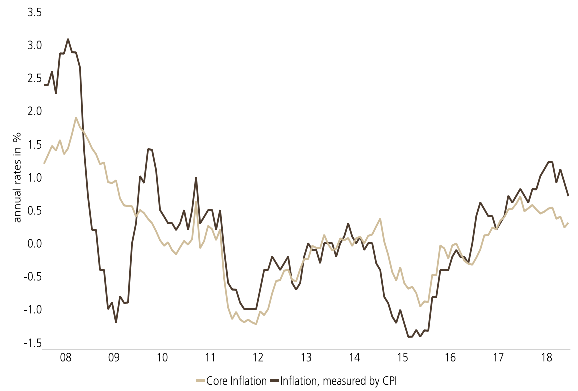
Swiss GDP growth and Manufacturing Purchasing Manager's Index



Source: Macrobond, UBS, as of 16 January 2019

CPI slowed to its lowest level in 10 months

Core Inflation and Inflation, measured by CPI, in %



Source: Macrobond, UBS, as of 16 January 2019

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Version 01/2019. CIO82652744