Year Ahead 2018

UBS House View

Asia Pacific
Chief Investment Office WM

Changing context

UBS


Longsheng, Guilin, China. iStock

Dear reader,

Welcome to Year Ahead 2018, our outlook on the year to come.

2017 was a year of contrasts. A year of uncertainty: rising geopolitical tensions in the Middle East and North Asia, fractious Brexit negotiations, and increased US unilateralism. But also a year of stability: the best year for global economic growth since 2011, with some of the lowest levels of equity market volatility since the financial crisis.

Will 2018 bring more stability, or more uncertainty? There are plenty of hurdles ahead: tighter monetary policy, political change, and technological disruption, not to mention huge environmental and social challenges.

How should investors react? In this Year Ahead, we look at how to respond to the changing monetary and political backdrop, detail the risks and opportunities resulting from technological disruption, and show how we can make a positive impact on our world, without sacrificing financial returns.

I hope this Year Ahead helps guide you and your portfolio through 2018 and beyond. We are committed to helping our clients navigate the markets and remain by your side to assist you in staying on track with your investment goals.

Jürg

Jürg Zeltner
President UBS Wealth Management

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Changing context

We expect another year of respectable economic growth, higher corporate profits, and rising equity markets. But investors will need to adapt to the changing monetary, political, technological, social, and environmental context.

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Top risks

Although we expect the rally in equities to continue, we see the three most prominent threats as: a significant rise in interest rates, a geopolitical conflict, and a China debt crisis.

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Dealing with change

To protect and grow wealth in a period of accelerated change, investors will need to demonstrate a combination of agility, balance, and calm, in our view.

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Around the world

To discover more about how the changing context will impact your region go to ubs.com/cio or use the QR-codes.

US

US growth should remain solid in 2018. We forecast a repeat of 2017's 2.2% rise in GDP, and expect two Fed rate hikes. Within equities, we like the financial sector, which could benefit from higher interest rates, and the technology sector, which is seeing secular growth as well as offering reasonable valuations relative to the market.

Emerging markets

Emerging markets are well-positioned for 2018's changing context. They are better prepared for monetary tightening than in the past, and technology is an increasingly important part of the EM index. Politics is a risk, but should be navigable for well-diversified investors. We see particular value in select EM credits.

Europe

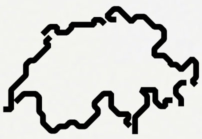
A stronger euro and Brexit uncertainty are likely to weigh on Europe's economy, whose growth we expect to slow from 2.2% to 1.9%. We are positive on Eurozone equities relative to the UK's, due to contrasting earnings dynamics. It is likely to be a tough year for euro credit investors. But we are optimistic on the euro, as investors gain confidence in its longevity.

Asia

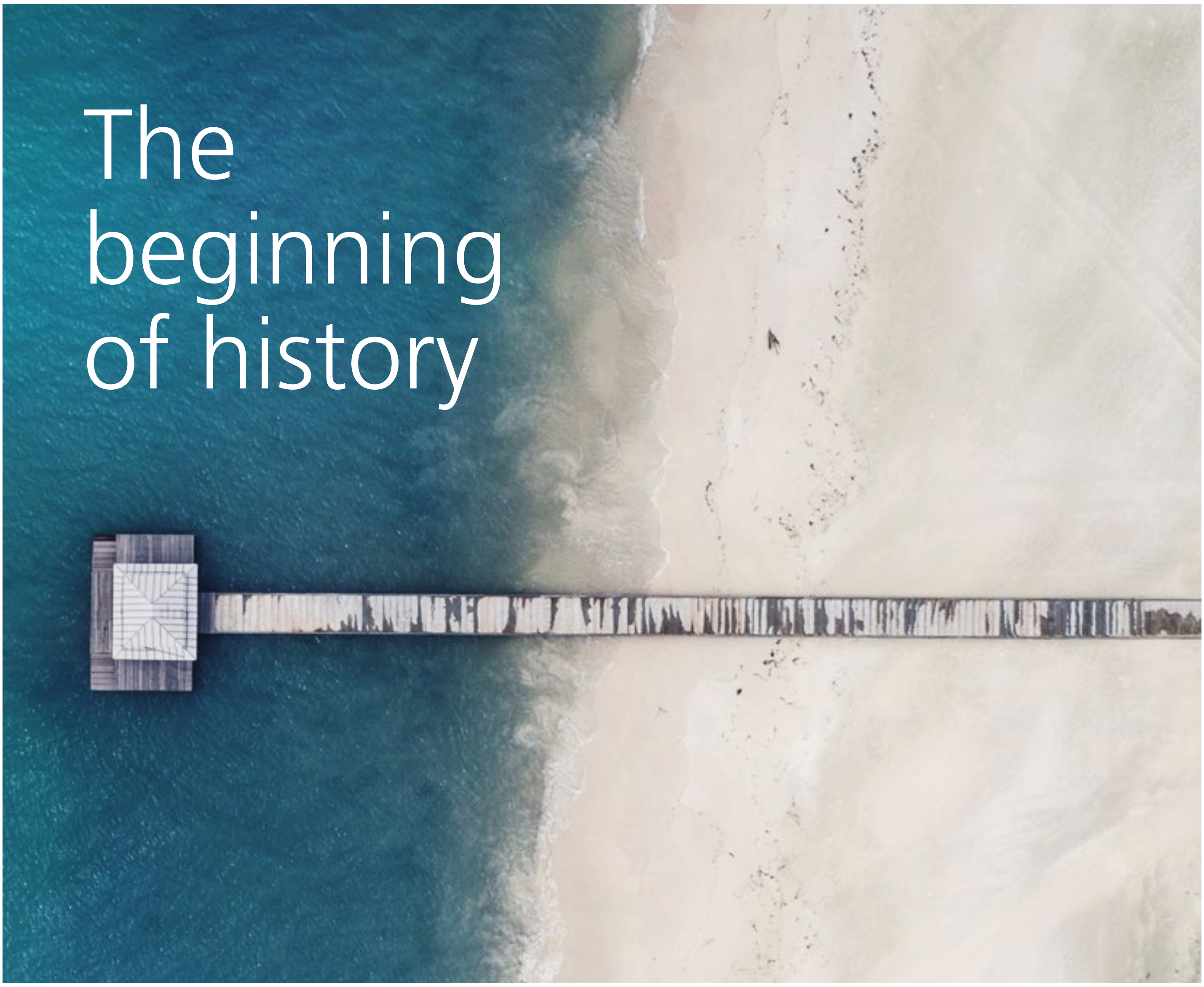
We see Asian economic growth of 6.1% in 2018, with innovation as a rising force in the medium term. We expect China to maintain its policy direction, balancing reform and growth. We particularly like Chinese equities and Asian high yield bonds, and also favor companies set to benefit from the tightening labor market in Japan.

Switzerland

We expect Swiss growth to accelerate to 1.8% in 2018 from 0.8%. The SNB is likely to hike rates once, toward the end of the year, and we foresee modest franc depreciation versus the euro. It will be tough to make money in bonds, whose yields are negative, and we see house prices remaining unchanged. In equities, we favor high-quality dividend payers.



The beginning of history



Maldives. Syd Sujuaan. Unsplash

Mark Haefele
Global Chief
Investment Officer
Wealth Management

A decade from now, how will we look back on 2017? As trivial or pivotal? At first glance it was straightforward: good growth and rising markets. But I think we caught a glimpse of something stirring out there in the deep blue.

Twenty-five years ago, Francis Fukuyama's *The End of History and the Last Man* hypothesized that the conclusion of the Cold War signaled "the end of history": the victory of free-market capitalism and liberal democracy as the final state of human sociopolitical evolution. Yet 2017's events raised questions about this hypothesis. To paraphrase Police Chief Martin Brody in the movie Jaws, "You're gonna need a bigger book."

Will the apparent peak of central bank stimulus begin a journey to "normalization," or will the developed world economies prove unable to perform without low rates and quantitative easing?

Does Chinese President Xi Jinping's speech on globalization at the World Economic Forum and the success of the One Belt One Road initiative show a new model of governance and development in China? Is it leaving increasingly fraught Western democracies behind, in a quagmire of Twitterstorms, growing inequalities, slower economic growth, and separatism?

Will a new reality of human DNA editing, neural implants, and artificial intelligence redefine what it means to be human, and create previously unimagined levels of inequality within and among nations?

And will China's massive investment in green technology lead the world toward a cleaner future, or will the US withdrawal from the Paris Climate Agreement start a race to the bottom on pollution and emissions regulation?

Finding a new way forward

Leaders and electorates are facing ever-more divergent options. And the consequences of their choices are perhaps less clear than at any point since the end of the Cold War. How will it play out? A golden, though probably unlikely, scenario is that heightened environmental challenges and the existential questions posed by science will bring countries and people closer together in the quest for unified solutions. A less-beautiful scenario, echoing the Cold War struggle, would see a clearly victorious set of choices emerge, with extended hardship for those caught on the "wrong" side.

In a status quo scenario, perhaps likeliest of all, economic, political, and scientific ideologies would continue to diverge, with ongoing disharmony, as governments and peoples deal with their problems in a piecemeal fashion.

Regardless of whether time proves 2017 trivial or pivotal, the world, in all areas of human endeavor, seems to have entered a period of greater ideological divergence about what is the "right" way forward – for the economy, society, government, science, and the environment. Investors will need to adapt to all these changes to protect and grow their wealth in the year ahead.

Stocksy

Changing context

We are positive on global equity markets as we enter the new year, amid robust economic growth and limited evidence of an impending downturn. But monetary, political, technological, social, and environmental contexts are all changing. Each will require investors to adapt.

Recovery remains on sound footing

Global economic performance in 2017 looks to have been the best since 2011. Growth accelerated in the US, the Eurozone, China, Japan, Russia, and Brazil, pushing GDP worldwide up to 3.8% from 3.1% in 2016, on our estimates. The expansion has been particularly impressive for its synchronicity. Only six other times in the past 30 years has every economy in the G20 grown.

As we look ahead, we forecast little change in the positive economic backdrop. Both the US and Japan are benefiting from strong labor markets and solid corporate profitability. Growth could moderate in Europe, weighed on by a stronger euro and Brexit uncertainty, and in China, where property construction is likely to slow in response to falling prices. But flourishing economies in Brazil, whose recovery from the 2015–16 recession continues, and in India, where the economic reforms of the past 12 months should start taking effect, should provide a positive offset.

Overall, we expect growth of 3.8% in the coming year, a repeat of the healthy current rate of expansion, see Figure 1.1.

Recession looks unlikely in 2018
Periods of high economic growth often sow the seeds of their own demise. But there is little evidence today of an impending recession. Historically, recessions have been caused by one or more of: oil price shocks, too-tight monetary policy, contractions in government spending, and financial/credit crises. None of these look likely to materialize in 2018.

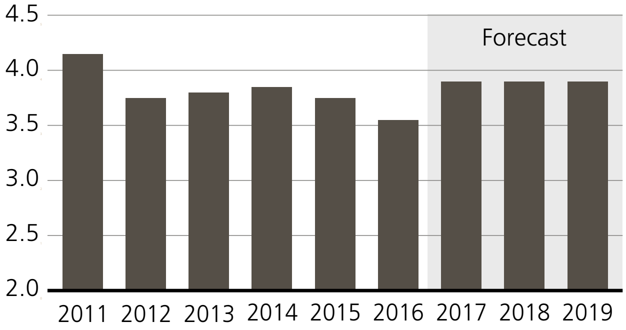
Oil prices are likely to move sideways. OECD inventories are around 10% above historical norms, providing a cushion even if supplies fall next year. Barring a significant rise in tensions in the Middle East, we expect Brent crude oil prices to trade at USD 57/bbl in 12 months' time.

Central banks are likely to err on the side of caution as they tighten policy. Inflation is stable, and core measures are likely to remain below central bank targets. We expect just two interest rate hikes in the US and Canada, one in Switzerland, Australia, and New Zealand, and the Eurozone, UK, and Japan to see rates on hold in the year ahead. Meanwhile, quantitative easing will be withdrawn only gradually in the US and Eurozone, and will continue in Japan.

Figure 1.1

Growth to remain healthy in 2018

Real GDP growth, global (%)



Source: UBS

In aggregate, governments are likely to keep net spending as a proportion of GDP broadly unchanged. The era of austerity in Europe is over, and tax changes in the US could widen deficits there. We foresee a global fiscal deficit of 2.9% of GDP in 2018, down only slightly from the current 3.0%.

And leverage does not appear to be a particular threat. The developed market private sector debt-to-GDP ratio is 164%, up minimally from a low of 161% in 2014, and down from a 2009 peak of 173% according to the Bank of International Settlements (BIS). While debt is climbing rapidly in China – it currently stands at 258% of GDP according to the BIS – the government is well-positioned to manage its rise. External debt (i.e. that owed to overseas lenders) is just 13% of GDP, making China less prone to crises of global confidence.

So barring an exogenous shock, such as a flare up in Middle Eastern tensions leading to significantly higher oil prices, or a conflict between the US and North Korea, we believe a downturn looks unlikely.

Long in the tooth?

In parts of the world the economic expansion has run for a long time. In the US, for example, continued growth in 2018 would make for the second-longest period of postwar expansion. Only the 1991-2001 run would have lasted longer.

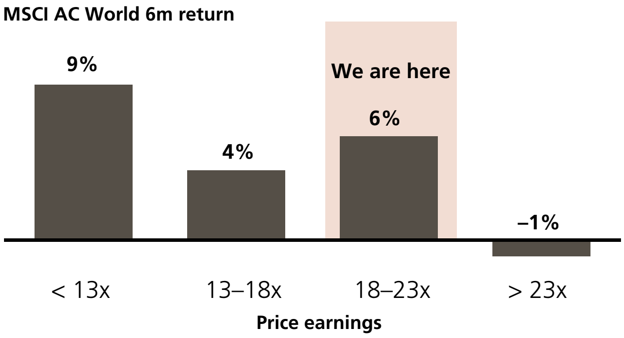
But we don't expect the boom times to just succumb to old age. The San Francisco Federal Reserve has shown that data since World War II suggests the probability of a recession does not rise significantly with the age of an expansion. Improved inventory management, a higher share of services in the economy, and more active policymaker management of business cycles have all contributed to a steadying of economic cycles.

Learn more. Put this economic cycle in context, and learn more about previous economic cycles, and what brought about their rise and fall.
ubs.com/cio

Figure 1.2

Valuations consistent with further upside

Average 6m subsequent total return MSCI AC World, for given price-to-earnings ratio



Note: Average total return of MSCI AC World index over the following 6 months when the valuation is in the indicated valuation bucket at the end of the month. Based on data since 1987.

Source: UBS, Thomson Reuters

Positive on equities

Overall, solid growth and limited evidence of an impending slowdown keep us positive on global equity markets as we enter the new year. At a price-to-earnings ratio of 18.0x, global equities are priced broadly in line with their long-term average (18.3x). Prices are not yet at levels that have historically presaged weak performance, though investors should not expect a repeat of the double-digit annualized returns seen in recent years. Historically, global equity valuations between 18x and 23x have been consistent with 6% subsequent 6-month performance, see Figure 1.2. And, much like in 2017, robust earnings growth should help push stock markets higher.

More generally, investors are wise to remember that avoiding taking profits too soon is critical for long-term performance. Since 1927, the average increase in the final 12 months before the end of a bull market has been 22%. Missing these periods would lower investors' long-term annualized price returns on the S&P 500 from 9.6% to just 7.2%.

Changing context

While our view on markets is positive, this does not mean the coming year will be easy for investors. The investment context is changing. Abnormally low levels of volatility may end on the back of monetary tightening, political flux, technological disruption, and sustainability challenges, which each bring their own set of opportunities and risks.

Monetary tightening: With almost a decade of monetary easing drawing to a close, investors will need to prepare for higher volatility and potentially higher correlations and stock dispersion. We see opportunities in the financial sector and, for investors looking to reduce portfolio volatility, in alternatives.

Political flux: The political calendar will raise risks to local markets, with a particular likelihood of heightened volatility in Brazil, Mexico, Russia, South Africa, Spain, and the UK. That said, US tax reform, and China's One Belt One Road initiative, could provide investors with politically-driven investment opportunities too.

Technological disruption: New technologies will both delight and disrupt. Investors with high weightings to individual industries under threat of disruption are at risk. But we see opportunity in companies enabling and adopting big data technology, those supplying automation and robotics solutions, and those that provide electronics and components for electric cars and autonomous driving.

Sustainability challenges: The world will continue to face myriad challenges ranging from climate change, to resource overuse, and economic inequality. While the near-term effect on markets is uncertain, the sustainable investing industry can enable investors to play an important role in the long-term solution, without sacrificing risk-adjusted returns.

Nobel Perspectives

How long is left in the cycle?
Edmund S. Phelps, Nobel Laureate in Economic Sciences 2006

The boom is still going strong in the US, and the booms developing in some other countries came as a surprise (as booms usually do). They seem to be based on a loss of pessimism, and perhaps a new-found optimism about the future. It looks like the growth rate of GDP in the US is running around 3.0% p.a., and I think growth may continue at that rate for several quarters, but much depends on the tax-cut legislation: I believe the boom in the US is likely to run on through 2018 if a tax cut is passed and signed, and likely to run down if there is no tax cut.

Looking forward, I expect that if the global growth in total factor productivity – a weighted average of labor productivity and capital productivity – is not significantly increased within the next four or five years, investment will return to the weak level relative to GDP that we have seen over the past decades. It seems to me that investors are already well-prepared for such a period of lower long-term returns.

Source: ubs.com/nobel

Monetary tightening

Central banks will tighten monetary policy in the year ahead. We see no cause for alarm, and higher rates could even usher in opportunities. But investors will need to prepare for higher volatility, cross-asset correlations, and stock dispersion.

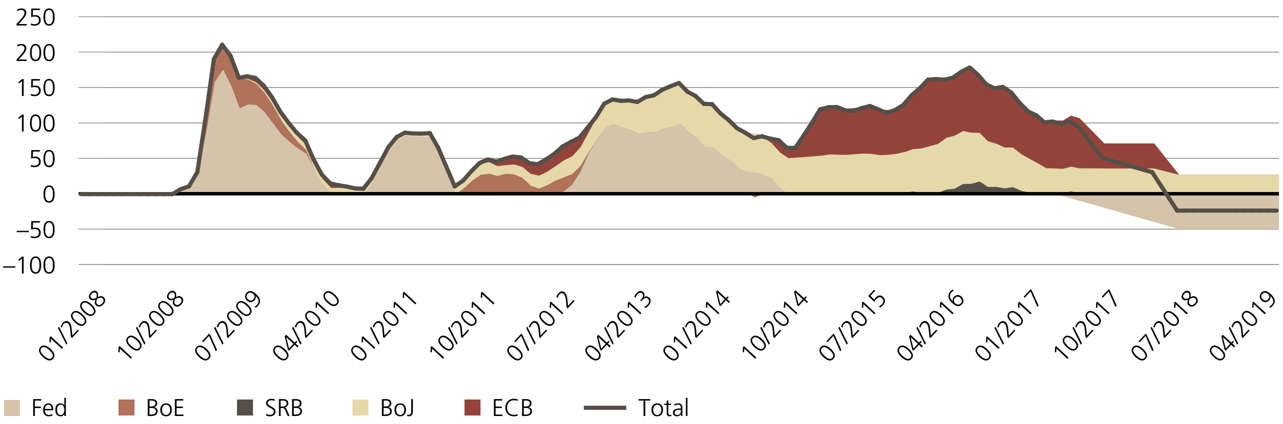
Investors are likely to hear a lot about tighter monetary policy in 2018. Central banks have spent almost a decade buying financial assets in an attempt to lower long-term interest rates and boost economic growth and inflation. But with global GDP expanding at its fastest pace in six years, many central bankers believe the economy is now strong enough for them to start withdrawing stimulus.

We expect the US Federal Reserve to reduce the size of its balance sheet by less than 10% over the course of the year, and to increase interest rates twice. The European Central Bank (ECB) is currently buying EUR 60bn of

Figure 1.3

Central banks will be withdrawing liquidity by end-2018

Monthly net securities purchases by the world's major central banks, in USDbn



Source: UBS, Haver Analytics

Nevada, United States. Anubhav Saxena. Unsplash

financial assets each month, but will reduce this to EUR 30bn monthly from January to September, and we see it winding up its asset purchase program by the end of the year. By the end of 2018, in our view, the Bank of Japan (BoJ) will be the only major central bank left providing monetary stimulus to the global economy, and in aggregate central banks will be net suppliers, rather than net demanders, of financial assets for the first time since the start of the financial crisis, see Figure 1.3.

No cause for alarm
Although the move away from monetary easing marks a change, as long as it remains consistent with the global growth outlook, we do not see cause for investor alarm.

The scale of tightening is likely to be limited. The Fed's "quantitative tightening" process is going to reduce the size of its balance sheet only modestly, and global central bank balance sheets will still grow overall, thanks to stimulus from the ECB and BoJ. Furthermore, given that the Fed estimates that its entire quantitative easing program lowered long-term bond yields by just 100 basis points, the impact on yields directly resulting from this round of quantitative tightening should be limited. We forecast US 10-year yields climbing to 2.5% by the end of 2018.

Central bankers remain responsive to economic data. They are only looking at raising interest rates in response to more robust growth, and their stance could be interpreted as a vote of confidence in the economy. Should global growth or inflation slow again, or should financial markets experience a significant dislocation, we would expect central banks to move to an easier stance.

Inflation is likely to remain contained. Unlike in previous interest rate-hiking cycles, most central banks are not under pressure to slow inflation, which has remained stubbornly below targets. While policy may become less accommodative, there is no need for it to become restrictive.

Finally, there are structural factors beyond quantitative easing that have helped suppress interest rates and bond yields in recent years. They are not changing. The ongoing retirement of the baby boomer generation is lowering prospective growth and reallocating savings toward fixed income. The development of low-capital-intensity industries is dampening demand for investment. And regulation continues to force pension and insurance fund managers to stock up on long-term fixed income assets. Between 70% and 80% of the US Treasury market, for example, is owned by investors who have no choice but to own them.

Find out more about the history of monetary easing, and its impact on markets in the past decade.

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Changing dynamics
That said, we do expect tighter monetary policy to change market dynamics.

Market volatility could increase as stimulus declines throughout the year. Investor confidence in central bank intervention has helped keep volatility close to record lows in recent years. Even if we think most central banks will retain an interventionist policy, their tighter stance could lead investors to doubt their willingness to intervene. And governments will need to find new private sector buyers for net new debt issuance.

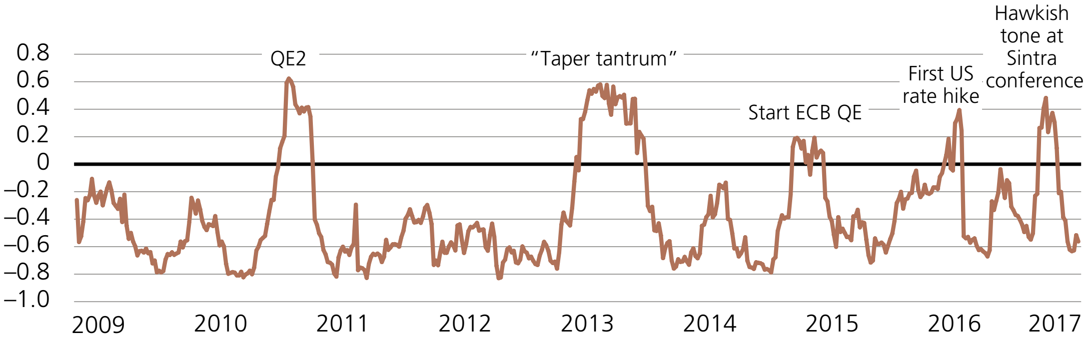
Bonds and equities could rise and fall together, should investors grow concerned about monetary policy. Historically, turning points in monetary policy have seen a rise in bond-equity correlations, as equities and bonds react to changing central bank policy, rather than growth, see Figure 1.4. This dynamic would increase portfolio volatility for investors diversified across equities and bonds.

And although bonds and equities might move in tandem, correlations between individual stocks could drop, as higher interest rates lead investors to discriminate more strictly between companies. For instance, we could see a shift away from bond-proxy equities, while interest rate-sensitive stocks and sectors, such as financials, could perform better. In such an environment, active managers might come to the fore, if intra-market correlations remain low.

Figure 1.4

Bond-equity correlations can turn positive at monetary turning points

13-week rolling correlation, S&P500, US 5-year Treasury



Source: UBS, Bloomberg

Martin Reisch. Unsplash

Investment ideas

US financials – higher interest rates generally boost bank net interest margins. To the extent that a reduction in monetary stimulus indicates a positive macro-economic environment, financials should also benefit from greater client activity, higher loan demand, and good credit quality.

Portfolio implications

- **Diversifying into alternatives:** At turning points in monetary policy, correlations between bonds and equities can rise, increasing portfolio volatility for investors. Diversification into alternatives, including hedge funds, could help reduce volatility.

- **Active management:** Reduced central bank support should make stocks more responsive to idiosyncratic factors. This could aid active managers, who have previously underperformed as central bank policy support helped all stocks move up together.

Political flux

Politics will again dominate headlines. We expect its global market impact to be limited, but it will both present risks and bring opportunities at a local level.

With Russia and China asserting their presence on the global stage, North Korea developing nuclear weapons, political instability in the Middle East, the UK negotiating its exit from the EU, mid-terms in the US, and elections taking place in Italy, Brazil, Mexico, Russia, and Malaysia, global politics is in a state of flux that will continue to play out through 2018.

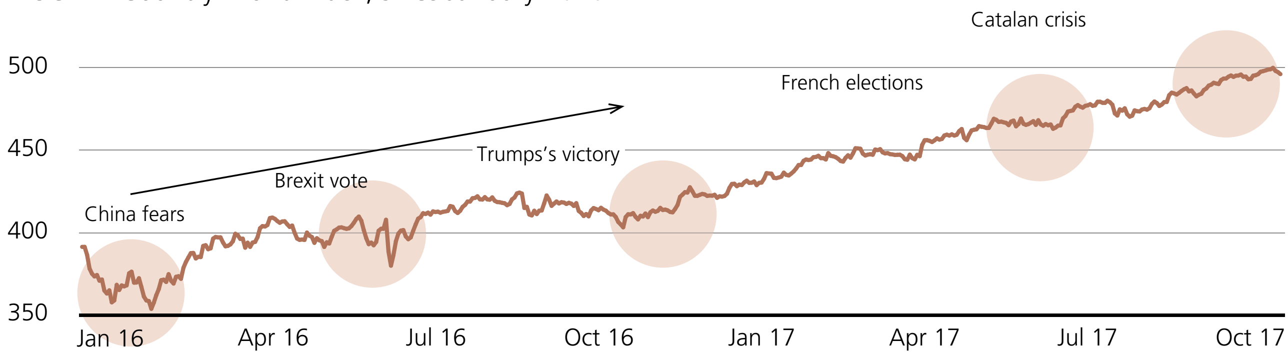
Economics, usually, trumps politics

The relevance of geopolitics for investors is debatable. Despite the significant media attention, and the plethora of political events and shocks in the past two years, the best strategy for investors would have been to turn off the 24-hour news and stay invested, see Figure 1.5. Equity markets rose and volatility plumbed record lows. Indeed, trying to trade the events could have been costly – the FTSE 100 lost nearly 9% in the immediate aftermath of the UK's EU referendum, before recovering within days, and closing the year sharply higher.

Figure 1.5

Markets have proven relatively immune to political risk

MSCI All-Country World Index, since January 2016



Source: UBS, Bloomberg

Barcelona, Spain. 2017. iStock

We don't think this calm represents market complacency. In general, we believe that the impact of domestic politics on global markets is overestimated.

Politics is often subjective. Events regarded as negative by one group can be interpreted as positive by another. Between October 2016 and August 2017, overall US consumer expectations, as measured by the University of Michigan, declined by 33 points among Democrat voters and rose by 47 points among Republicans. This balancing effect can neutralize the impact of politics on consumer and business confidence.

The effect of political events also tends to be local and may not move markets internationally. Britain's exit from the EU, Catalan separatism, sanctions on Russia, and modifications to the North American Free Trade Agreement (NAFTA) might have meaningful effects on the UK, Spanish, Russian, and Mexican markets, respectively, but their relative impact on global markets is much smaller, and individual political issues can cancel one another out.

And since markets focus on long-term cash flows, policies instituted by a government whose mandate will expire tend to get discounted somewhat.

Test your ability to assess the impact of geopolitical events on markets, using historical case studies ranging from World War II to the Cuban Missile Crisis and Brexit.
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Specific potential impacts

While we don't expect politics to sway global markets in the coming year, it can affect investors in three specific circumstances: First, if events are extreme, such as wars. The 1940 Battle of France caused the Dow Jones to decline by 14% in the week of the invasion. And the oil crises of the 1970s and early 1980s, resulting from the Yom Kippur War (and associated embargo), and the Iran-Iraq War, contributed to global financial market turmoil. In this regard, we will be monitoring geopolitical risk, notably in the Middle East and on the Korea Peninsula, particularly closely.

Second, if the global economy suffers a downturn. With interest rates still at low levels, and the marginal returns from quantitative policy diminished, fiscal policy could have a larger role to play in supporting growth after the next global downturn than in the last, when central banks played an arguably larger role.

Finally, since the impact of politics is greater at a local level than at a global level, even relatively minor local political events can affect investors who are too heavily concentrated in individual regions or sectors.

Local geopolitical risks in 2018 – exposed investors should seek diversification

Event	Affected country	Description
Brazil election	Brazil	Victory by a populist candidate in next year's presidential election could derail the reform progress and lead to further deterioration of the fiscal condition.
NAFTA negotiations	Mexico	Hiccups in the NAFTA negotiation, a potential Lopez Obrador administration, and inflation stoked by a weak peso could all cause Mexican assets to underperform.
US Treasury report on Russia	Russia	As the US Treasury prepares a report to be delivered by February, possible new sanctions from the US could raise the risk premium on Russia assets.
ANC conference	South Africa	Amid the country's bleak growth and fiscal situation, the new leader elected at the ANC conference in December may bring changes – for better or worse.
Catalonia separatism	Spain	Ongoing political uncertainty over the political status of Catalonia could boost volatility for Spanish assets.
Brexit negotiations	UK	Uncertainty about Brexit could result in higher volatility for UK asset prices as negotiations progress.

iStock

Investment ideas

We see the potential for politically-inspired volatility in Brazil, Mexico, Russia, South Africa, Spain, and the UK. Regardless of our base case view on the individual regions, the threat of political uncertainty means that we believe investors heavily exposed to these markets, and particularly those local investors with a large home bias, should seek overseas diversification.

Meanwhile, we see politically driven opportunities in the US and China, related to US tax reform, deregulation, and the One Belt One Road initiative.

- **US tax reform:** A reduction of the US corporate tax rate to 25%, and repatriation of foreign earnings could boost US earnings per share by up to 10%.
- **US deregulation:** Legislation or actions from the Trump administration could lessen the impact of the Affordable Care Act. Meanwhile, changes to environmental and financial regulations could boost the energy infrastructure and financials sectors.
- **One Belt One Road:** China's investment in One Belt One Road infrastructure projects is gaining momentum. We see spending doubling in the next five years to USD 90–160bn and regard emerging market infrastructure companies as the biggest beneficiaries.

Portfolio implications

- **Regional diversification:** Investors looking to reduce exposure to local political risks should seek regional diversification.
- **Asset class diversification:** Although we expect fixed income to underperform equities in 2018, a mixture of the two asset classes can help insulate portfolios against geopolitical risk.
- **Rebalancing:** The effect of geopolitical events can often be short-lived, and committing to a regular portfolio rebalancing strategy can aid in navigating political uncertainty. Systematic rebalancing could improve pre-tax performance by as much as 80 basis points per year.

Nobel Perspectives

The geopolitical impact of the America-first presidency
Roger B. Myerson, Nobel Laureate in Economic Sciences 2007

President Trump's 2018 budget blueprint includes plans to increase military spending. But the proposed new investments in military hardware are not likely to make any difference for America's geopolitical power. Recent frustrations of US foreign policy have not been due to any lack of military capability, but instead have been due to a weakness of diplomatic capabilities for turning battlefield successes into positive political developments.

A nation's power in international affairs depends as much on its ability to make credible long-term commitments as on its military might. In this regard, President Trump's shift to an opportunistic America-first policy could actually weaken America's ability to achieve foreign-policy goals. Withdrawal from major international agreements will make it harder to build confidence in any newly negotiated promises. In this environment, the best hope for effective containment of North Korean militarism may be found in security agreements directly between China and South Korea, even though such agreements could be interpreted as evidence of a decline of American influence in Asia.

Meanwhile, NAFTA is at risk after being blamed by the President for contributing to America's longstanding trade deficit. But this trade deficit has been driven primarily by strong international demand for US debt, based on global confidence in the stability and reliability of the United States government. America-first policies could erode this confidence and weaken global demand for US debt, resulting in US federal deficits becoming harder to finance under Trump than under Obama or Reagan. The result could be higher US interest rates after tax cuts in 2018.

Source: ubs.com/nobel

Technological disruption

We are living in a time of rapid technological development. We see particular opportunities in digital data, automation & robotics, and smart mobility. But investors heavily exposed to individual companies or sectors are at risk of disruption.

Technology is developing rapidly. Quantum computers can process data 100 million times faster than any traditional computer. The first driverless cars are loose on our roads. Earbuds can translate dozens of languages in real time. And tech pioneers are setting their sights on even grander goals. Scientists are developing living solar panels that can be printed on paper, and have made strides in their ability to perform surgery directly on DNA. Elon Musk's Neuralink, meanwhile, aims to enhance the human brain with implants, envisioning a future of telepathic communication.

Some of these developments will prove to be more hype than substance. As the dotcom bubble showed, alluring visions don't necessarily tally with attractive investments, even if they are ultimately proven right. Technologies may take too long to develop, companies may be unable to monetize their growth, and investors may miscalculate the sector that value ultimately accrues to.

But technology is having a very real impact too. In the most recent quarter, technology firms accounted for 23% of S&P 500 earnings, up by 5ppts in three years. The tech sector is now the largest in the MSCI Emerging Market and MSCI China indices. The number of patents granted has doubled over the past decade, with 1.2 million approved worldwide in the last year of data. And the US Bureau of Labor Statistics estimates that the economy will need 30% more software developers over the coming decade, the fastest- growing highly paid job.

Investment opportunities

We remain confident on the shorter-term prospects for the US technology sector. We project 2018 earnings growth of 12–13%, and see price-to-earnings ratios of 19.3x as reasonable. They currently trade on a 7.5% premium to the market relative to a 25-year average of 22%. But longer term we see the most compelling technology-related opportunities in three areas.

Chuttersnap. Unsplash

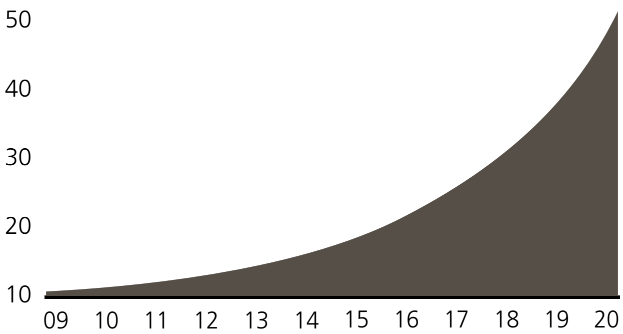
Digital data: The volume of global data is growing exponentially. By 2020 the digital universe will be 44 zettabytes large, equivalent to 318 iPhones per household, a 50-fold increase from 2010 levels, according to industry research firm IDC, see Figure 1.6. Dramatic declines in the cost of gathering, processing, storing, and analyzing data has made it a crucial global commodity dubbed "the new oil." Yet the vast majority of that data remains unexploited. Companies that invest across the data lifecycle – creation, transmission, storage, processing, consumption, and monetization – are well positioned for above-average growth, in our view.

Automation & robotics: The world is undergoing a fourth industrial revolution. A combination of factory and process automation, additive manufacturing technology, and artificial intelligence is transforming the way we manufacture and distribute goods. The number of "Internet of Things" devices is soon set to surpass the number of people on the planet, see Figure 1.7. And the International Federation of Robotics expects 160,000 robots to be installed in China alone by 2019. We anticipate companies exposed to the theme posting c.13% higher earnings per share in 2018, versus

Figure 1.6

More than 50x growth in digital data by 2020

Digital universe in zettabytes

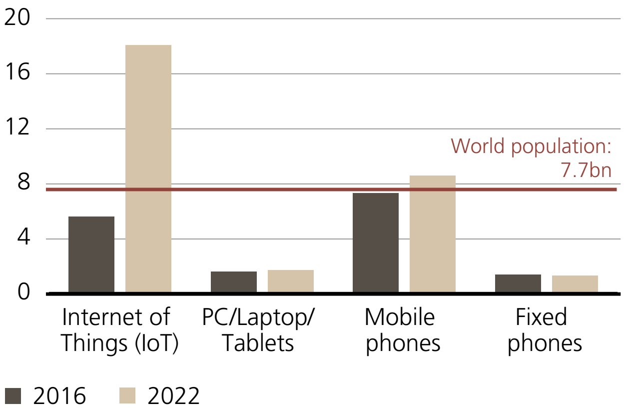


Source: IDC, EMC, UBS

Figure 1.7

More IoT devices than people

Units in billions



Source: Ericsson, UBS

Filip Filkovic Philatz. Unsplash

8–12% for the global equity market as a whole, with industrial software at the forefront.

Smart mobility: Regulatory action and technological advances have pushed us to the cusp of a boom in smart mobility: electrification of vehicles, autonomous driving, and car-sharing business models. We expect the addressable market to grow tenfold by 2025, with an inflection point in the uptake of electric cars approaching. In the coming year in Europe, we estimate that the total cost of owning a battery-powered electric vehicle will fall below that of a vehicle with an internal combustion engine for the first time. Inflection points should follow in China by 2023 and in the US by 2025. We see particular opportunities in companies that supply electronics and electric components related to electrification and autonomous driving.

Portfolio implications

- **Avoiding single-stock and sector concentration:** Investors concentrated in companies or industries threatened by disruption are at particular risk in an age of rapid technological change. In 2017, the food retail sector fell by 11% in the week that Amazon announced it would purchase Whole Foods, potentially sparking a price war. Diversification across companies and sectors is key to mitigating this type of risk.

Discover the technology that we believe could have a transformative effect on industries around the world.

ubs.com/cio

Long-term themes

Digital data, automation & robotics, and smart mobility all form part of our Longer Term Investments, a series of thematic investment ideas that should benefit from secular trends such as population growth, aging, and urbanization. A diversified holding of Longer Term Investments could well offer superior earnings growth to global equities as a whole, through multiple economic cycles, in our view.

Nobel Perspectives

Is technology becoming a risk to jobs?
Sir Christopher A. Pissarides, Nobel Laureate in Economic Sciences 2010

Ever since the industrial revolution, new technology has been replacing human labor. Steam power, the internal combustion engine, electricity, and the computer destroyed jobs previously done by humans. Each time, new jobs were created that had the potential to make everyone better off.

Again this time new jobs will appear to replace the ones that robots and artificial intelligence destroy because there are still many things that robots cannot do; such as jobs that involve decision making in unpredictable environments. And with robots doing the work, we will be able to work less and enjoy more of the products of the new technology in our leisure time.

But like globalization, new technology can only benefit everyone if we manage the transition well. CEOs will have to see how they can combine robotics with labor, and be prepared to look outside the box for the things that the new technologies can do. Workers need to be more flexible in their skills, and in the jobs that they are prepared to contemplate. And governments need to make sure that human decency and high standards are maintained in the new work environment and not panic into blocking the advance of new technology. The education needs of a country need to be re-thought, and the support mechanisms for workers initially losing out expanded.

Source: ubs.com/nobel

Sustainability challenges

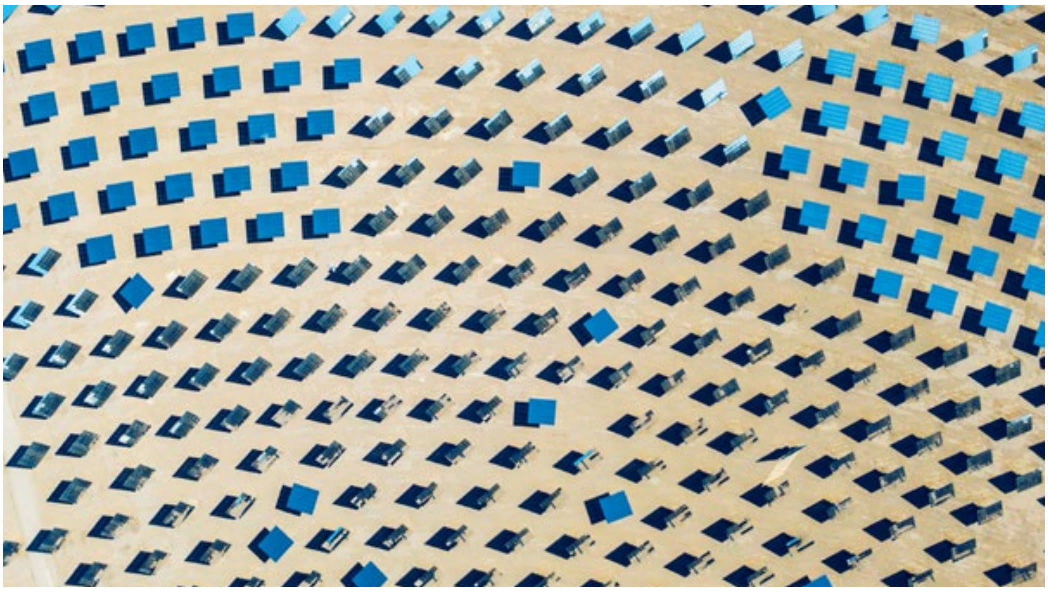
The world will continue to grapple with environmental and social challenges in 2018. Whether there is any progress in solving them in the face of global disunity remains to be seen. But investors can play an important role in furthering and funding solutions without sacrificing risk-adjusted returns.

The world economy continues to expand in a manner that cannot be maintained indefinitely. Atmospheric carbon dioxide levels are the highest they've been in three million years, contributing to more frequent extreme weather events. Use of natural materials has tripled in the past 40 years, leading to increased environmental degradation and challenges with urban pollution. And close to one billion people still live on less than USD 2 per day, lack access to clean water, and suffer undernourishment, contributing to the growing challenge with global migration policies.

Figure 1.8

UN Sustainable Development Goals

Source: UN



Solar power station. Nevada, USA. Getty Images

Investors could have an important role to play in the solution. In 2015, the UN created its Sustainable Development Goals (SDGs) resolving to, among other things, end poverty, combat climate change, and fight injustice, see Figure 1.8. The UN acknowledges that social and legal structures have a role to play, but also recognize that fulfilling this ambitious set of 17 goals will require both public and private investment across all forms of capital – physical, human, and environmental.

This demand for private capital within the SDG framework, and the rapid evolution of the sustainable investment industry across a broader range of asset classes, and with greater depth, means that investors now have an opportunity to make a positive impact on some of the world's most pressing issues, without sacrificing risk-adjusted returns.

Investment ideas

Green bonds: One of the fastest-growing segments of the fixed income market, green bonds are conventional fixed income instruments in which the proceeds are earmarked specifically for projects with environmental value. One can invest, for example, in bonds that target renewable energy, energy efficiency, sustainable waste management, sustainable land use, biodiversity conservation, clean transportation, and clean water/drinking water. We believe one could expect diversified green bond exposure to generate returns comparable to a mix of traditional high grade and investment grade corporate bonds.

Multilateral development bank bonds: Multilateral development banks (MDBs) like the World Bank Group play a critical role in providing development where it is needed most. In recent years, they have financed: irrigation services for more than two million hectares of land; access to an improved water source for 42 million people; and the reduction of 588 million tons of CO_2-equivalent emissions annually, according to the World Bank. Bonds issued by these banks are typically AAA rated, are backed by multiple sovereign governments, have never defaulted, and can be considered, in our view, comparable to high grade bonds such as US Treasuries.

Equity strategies: By diversifying across sustainable equity strategies, investors can expect to earn returns comparable to those available from a standard globally diversified equity portfolio, while making a positive environmental and social impact.

– *Thematic:* By investing in companies likely to see increased demand as they address the world's environmental and social challenges, investors can both benefit from, and support, the solutions such companies offer. Our longer-term investment themes include numerous companies involved, for instance, in expanding water infrastructure in, providing renewable energy for, and delivering healthcare equipment to emerging markets.

– *ESG Leaders:* Leaders in environmental, social, and governance (ESG) standards are those companies that not only avoid major adverse effects on society and the environment, but also seek to influence their wider industry in improving sustainability standards. Many of these firms view ESG factors as opportunities to improve financial returns. Empirical evidence suggests that it is possible to construct portfolios with an above-average sustainability standard while still achieving a risk/return profile that is comparable to "conventional" investments.

– *ESG Improvers:* Investors can help reward improvements in corporate behavior with respect to social and environmental issues by tilting allocations toward companies that have shown significant signs of improvement in recent months and years, and away from companies whose ESG performance has deteriorated. We expect that investment strategies capitalizing on ESG momentum should be able to deliver performance in line with, or better than, broad-market benchmarks.

– *ESG engagement:* Fund managers can also employ a shareholder engagement approach to push company management into making ESG improvements. This can have a direct impact. For example, according to data compiled and analyzed by Ceres, of 779 climate-friendly shareholder proposals filed from 2013 to 2017, 36% were adopted without the need for a vote after investors and the companies in question agreed that more needed to be done to make sufficient progress in this area, i.e. by reducing their carbon footprint.

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Impact investing: Impact investing is a key means of mobilizing private wealth to address pressing global challenges and achieve the UN SDGs by 2030. Return-seeking private capital is best suited to addressing those SDGs where a market price can be attached to capital and where regulatory change is not as essential. These areas include alleviating hunger by improving food production and distribution, improving access to and quality of healthcare and education, and clean and affordable energy, among others.

Portfolio implications

With the sustainable investment industry now sufficiently broad and deep, a fully diversified portfolio of sustainable investments can be constructed. We believe it can provide similar risk-adjusted returns to those available from a traditional diversified portfolio:

Traditional asset class	Equivalent sustainable or impact investment
Global equities	ESG Themes ESG Leaders ESG improvement ESG engagement
High grade bonds	MDB bonds
Investment grade credit	Green/climate bonds ESG Leaders
Private markets	Impact private equity Impact private debt

How did we do last year?

One year on from the publication of the Year Ahead 2017, we look back at some calls we made that proved right, and some that did not.

Right

"We forecast the euro and the British pound appreciating relative to the US dollar in 2017."

Against the US dollar, the euro rose to 1.18 and the British pound to 0.89, from 1.06 and 0.86 at the time of writing in late 2016, respectively.

"We are positive on US equities, anticipating 8% earnings growth in 2017."

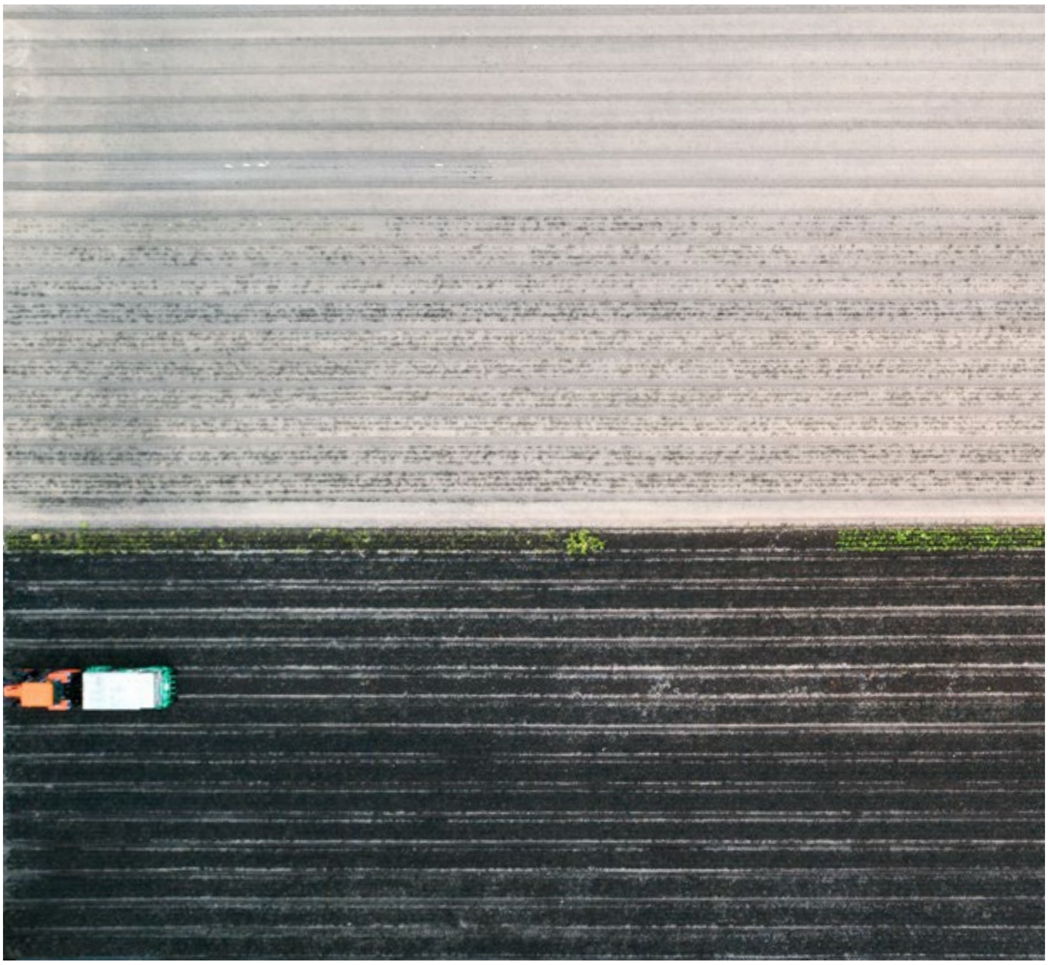
US equities have risen 17% since our publication date, with 2017 earnings growth surpassing our estimates, up 10%.

"In spite of political uncertainty, we are positive on emerging market (EM) equities."

EM stocks climbed 34%, aided by rising commodity prices, a falling dollar, and stronger-than-expected growth across the region.

"We expect oil prices to trade at USD 60/bbl in 12 months."

Oil prices are currently trading at USD 63/bbl, from USD 49/bbl at the time of writing in late 2016.



Martin Forster, Unsplash

Wrong

" We anticipate Eurozone growth of 1.3% in 2017, down from 1.6% in 2016. We expect Eurozone earnings growth of 5–9%."

Eurozone growth surprised us to the upside, reaching 2.3%, and earnings also surprised us positively, up 10%.

" We expect China to manage its slowdown effectively, with growth of 6.4%."

China managed its slowdown so effectively that its GDP growth rate actually rose, exceeding our expectations. Growth for 2017 looks set to be 6.8%, up from 6.7% in 2016.

" We expect the Federal Reserve to hike rates once in December and twice in 2017."

The Fed did indeed hike rates once in December 2016 and has done so twice so far in 2017, but we think a third 2017 hike now looks likely in December.

Johannes Schwaerzler. Unsplash

Top risks

The changing context brings risks that could weigh on global markets in 2018. While there are many known unknowns, and unknown unknowns, that could affect investors next year, we see three risks as the most prominent: sharply higher inflation might force central banks to tighten policy aggressively, hurting growth; geopolitical shocks could emerge from North Korea's nuclear weapons testing and from political instability in the Middle East; and China could mismanage its rising debt, leading to a greater-than-expected economic slowdown.

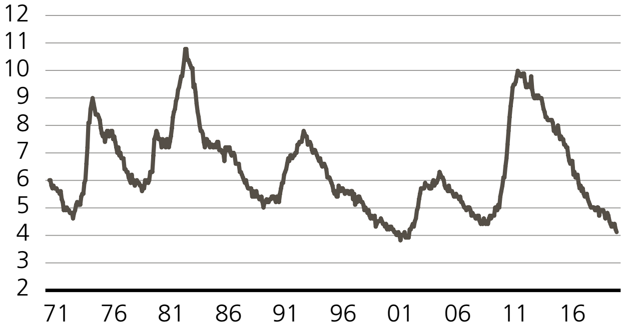
Much higher rates

In our base case, we expect central banks to tighten monetary policy only modestly. Inflation should remain muted, and there are few readily quantifiable signs of excess. But significantly higher rates are a possibility.

Figure 2.1

US unemployment close to a post-1970s low

US unemployment rate (%)



Source: Bloomberg

The risk scenario

Two circumstances could arise that might prompt central banks to act more boldly, in our view. They are: a) an unexpected surge in inflation, or, b) a dramatic change in how members interpret economic data.

An abrupt change in philosophy seems unlikely. Key central bank personnel remain the same in most regions, and the nomination of Jay Powell as new Fed Chair suggests continuity at the Fed. Powell has served at the US central bank since 2012, and has supported the current set of policies.

But a sudden rise in inflation cannot be ruled out. A sharp rise in oil prices owing to a supply outage in the Middle East is one outside risk. But an arguably greater risk comes from the possibility of rising wages and prices in the US. At just 4.1%, US unemployment is close to its lowest level since 1970, see Figure 2.1.

Although wage growth remains subdued for now, it is possible that a tipping point could occur if companies face sufficient difficulty hiring that they are forced to raise wages markedly to attract and retain staff. Similarly, if companies are running at full capacity and are

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unable or unwilling to expand production, they might raise prices to try and contain demand.

Although an increase in inflation isn't necessarily a bad thing in itself, should it become apparent that inflation is increasing too quickly, the Fed could be forced to raise interest rates rapidly to restrain demand. This would increase the risk of recession: every US downturn in the past 45 years has been preceded by a steep rate hike cycle by the Fed.

Market impact

Slower growth and heightened uncertainty over the course of inflation and interest rates could prompt investors to demand higher risk premia for equities and credit. In previous US recessions, a downturn in economic growth was preceded, on average, by a 20% correction in the S&P 500. A correction of that magnitude could be expected to be accompanied by lower commodity prices, and reduced long-term bond yields.

Lessons from history

Inflation running above target and Fed rate hikes don't always immediately lead to a market downturn. Core inflation ran slightly above the Fed's target from 2005–07. During that episode, the yield curve inverted, but equities continued to perform well through the hiking cycle, supported by strong economic growth. But the cumulative impact of higher rates ultimately contributed to a decline in the housing market, creating a catalyst for the unwinding of large economic imbalances, which culminated in the financial crisis.

Key signposts

The leading indicators we will be watching closely to determine if the probability of much tighter policy is rising include:

– Average hourly earnings increases exceeding 3.5% (currently 2.4%).

– Core personal consumption expenditure inflation rising above 2.5% (currently 1.3%).

– Five-year/five-year breakeven inflation expectations surpassing 2.5% (currently 1.8%).

– Two-year yields rising above 2.5% (currently 1.7%).

Investment ideas

– **Hedge funds:** They have historically outperformed other asset classes when monetary policy tightens, returning an average annualized 11% versus 8% for the S&P 500 during the 1994–95, 1999–2000, and 2004-06 hiking cycles. They also provide diversification in case of higher equity-bond correlations.

– **Long-duration high grade bonds** as part of a well-diversified portfolio. Although our base-case outlook on longer-duration high grade bonds is negative, the downside in absolute terms is likely to be relatively limited, given the structural support they enjoy from aging populations and regulation. Meanwhile, they could be expected to rally in the event that the Fed provokes a recession.

Portfolio consequences

– **Regional diversification:** It is unlikely that every monetary region would simultaneously run into labor shortages or capacity constraints that would necessitate higher interest rates. By diversifying across monetary blocs, investors can continue to benefit from rising markets while insulating themselves against the risk of greater inflation.

– **Currency hedging:** By ensuring the currencies of assets are matched to the currencies of liabilities, investors can minimize their exposure to potentially sharp currency moves that could arise from abrupt monetary policy changes.

Geopolitical shocks

In our base case we do not expect flashpoints on the Korean Peninsula or in the Middle East to disrupt markets. We see little incentive for either North Korea or the US to make a "first strike." And the recent unease in the Middle East we view as part of long-running tensions between Saudi Arabia and Iran rather than the start of something potentially more serious. But even a small chance of a geopolitical shock bears monitoring.

The risk scenario

– **North Korea:** Although we consider a "first strike" unlikely, North Korea's nuclear tests raise the risk and consequence of miscalculation. For instance, test missiles could miss their intended neutral targets, sparking retaliation, or North Korea could miscalculate the location or intention of US warplanes, which regularly conduct exercises in the region. The potential threat to Japan and South Korea, the world's third and eleventh-largest economies, respectively, means any conflict, or fear thereof, could have global consequences.

– **Middle East:** Saudi Arabia is the world's largest oil exporter, and controls most of the market`s 2.5–3 million barrels a day of spare capacity. Its recent increase in tensions with Iran has raised the risk of a disruption to oil supplies. If proxy wars between Iran and Saudi Arabia upset energy exports, and if this coincided with renewed sanctions on Iranian energy exports, the oil price, we believe, could reach USD 80/bbl and stay there for three to six months.

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Market impact

In the case of a military escalation, we would expect risky asset classes to sell off, particularly those in the regions where conflict is occurring (i.e. APAC or MENA). Traditional safe-haven assets such as Treasuries, and so-called safe-haven currencies, such as the USD and CHF, should benefit. This could mean that, counterintuitively, the Japanese yen could also appreciate, as it has at times this past year, in the event of rising tensions on the Korean Peninsula.

Lessons from history

The Cuban Missile Crisis is perhaps the closest parallel to the situation with North Korea, and shows how stocks are likely to remain calm right up to the moment of actual conflict. The Dow Jones fell 2% during the crisis, even with the world then arguably closer to a Third World War than at any point before or since.

During previous episodes of large oil supply shocks such as the Iranian revolution in 1979, and the Iraqi invasion of Kuwait in 1990, global equities fell by about 15%, but recovered within six months.

Key signposts

Given that most of the scenarios posit a relatively sudden escalation, monitoring the risk of a conflict will be challenging. We will be focusing on:

– **North Korea:** We will be watching for evidence of its technological development. The closer the country comes to creating a nuclear-enabled intercontinental ballistic missile, the greater the risk and consequence of accidents or miscalculations. Increased signs of military readiness in the US, North Korea, South Korea, or Japan could also provide cause for concern.

– **Middle East:** Potential red flags would be raised by a proxy war in Lebanon, pitting Saudi Arabia against Iran, in addition to the conflict in Yemen, tensions in Iraq, and the spat between the Saudi-led block and Qatar. This might include the US issuing sanctions against Hezbollah. The worst-case scenario would be a direct confrontation between Saudi Arabia and Iran.

Investment ideas

Investors looking to take a more active approach to protecting their portfolios against geopolitical risk might entertain a number of ideas that could fare well both in our base-case and in our tail-risk scenario:

- **Overweight gold and silver against industrial metals:** In our base case, we believe the upside for base metals is limited and expect low real rates to support precious metals such as gold and silver. Meanwhile, any escalation of geopolitical tensions should be expected to boost the price of gold and silver, still perceived as safe-haven assets by market participants.

- **Overweight Chinese stocks against Taiwanese equities:** Taiwanese equities typically underperform in global risk-off periods, an outcome we would expect to repeat itself in the event of rising North Korea tensions given Taiwan's highly trade-dependent market. Even in our base case we expect China to outpace Taiwan: while China's economy is strong and its domestic liquidity healthy, Taiwan's prospects are muted in the near term, in our view.

- **Overweight energy equities:** Should oil prices move sustainably higher, energy companies could be expected to benefit. And even in our base case, where prices remain flat, the average dividend yield of 6% offered by European energy firms is both attractive and safe. After a cost-cutting drive during the period of low oil prices after late 2014, free cash flows have been climbing. US energy firms meanwhile have underperformed as investors awaited assurances that the oil price can hold above USD 50/bbl. As such confidence increases, we expect a period of improved performance.


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Portfolio consequences

- **Regional diversification:** Conflict in North Korea would have global implications, but would likely prove particularly severe for investors concentrated in Asia. Meanwhile, the effects of an oil-price spike on markets would differ, favoring exporters but damaging importers. Those looking to reduce exposure to these risks should look to diversify across global markets.
- **Asset class diversification:** Although equity markets would likely fall in the event of outright conflict, high-quality bonds could prove a safe haven and help shield well-diversified portfolios from losses.
- **Staying invested:** Historically, geopolitical tensions, oil-price spikes, and even military conflicts have had only short-lived effects on global equity markets. Generally, staying invested through the noise has proven more effective than attempting to trade events.

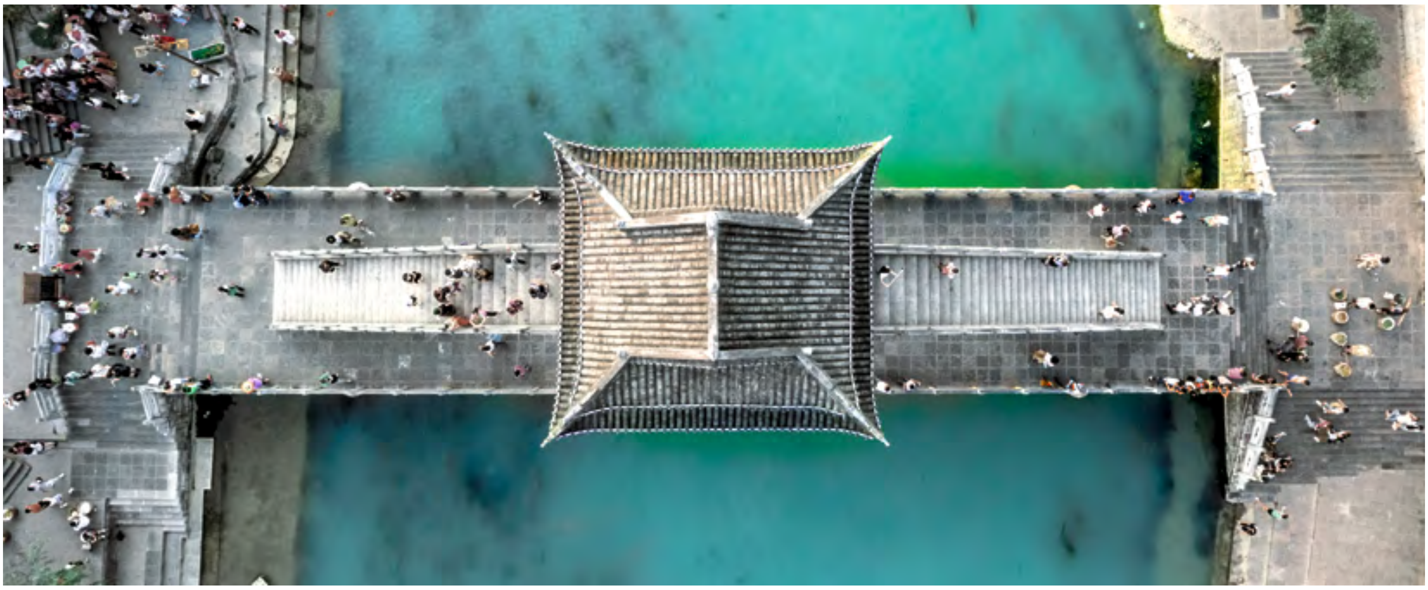
China debt crisis

China's high growth rate, powerful state apparatus, low external debt, and closed capital account make it less susceptible to debt crises, and our base case is for its economy to continue expanding at a robust, albeit slower, pace. But debt is rising rapidly.

China's total non-financial sector debt rose from 145% of GDP in 2007 to about 257% in 2016, and has increased by about 20 percentage points a year for the past three years. Total bank assets in China hover around 310% of GDP, nearly three times higher than the emerging market average.The Chinese government has recognized that the leverage build-up in the economy is unsustainable, and has emphasized the need to improve the "quality" of economic growth, pivoting from an economic model based on borrowing and investment to one fueled largely by domestic consumption.

The risk scenario

Credit risk is colloquially referred to in China as a "Grey Rhino," due to its potentially uncontrollable nature. In the words of the outgoing People's Bank of China Governor Zhou Xiaochuan, "If we're too optimistic when things go smoothly, tensions build up, which could lead to a sharp correction, what we call a Minsky Moment. That's what we should particularly defend against."



Stone Bridge in Fenghuang County. iStock

We see two potential ways in which markets could grow fearful of a debt crisis in China:

The first, and most likely of the two, in our view, is for one or more smaller-scale credit crunches to emerge at a regional or sector level. Some sectors have significant overcapacity issues, and several large Chinese companies in the insurance, real estate, and aviation sectors are already showing initial signs of credit problems.

If clusters of credit defaults start to form, concerns about contagion into the wider economy could take hold if fears of default in wealth management products arise. Should this happen, the Chinese government, in our view, would likely have sufficient resources to prevent widespread contagion. But global financial market volatility could increase until the situation is contained.

A second potential route is if the government miscalculates and takes steps toward capital account liberalization that backfire and spark a renewed spell of capital outflows from the country. As in 2015, global concerns could arise about China running short of reserves and needing to significantly devalue its currency, potentially hurting companies that supply goods and commodities to the Chinese economy. Again, we believe that the government is likely to be able to contain this risk through targeted regulation, as it has before, but market concerns cannot be ruled out.

Market impact

If China starts to experience a credit event, Asian equities would likely fare worse than equities in the rest of the world. Weakness in the Chinese credit sector could spill over into the rest of Asia and raise temporary concerns about the broader health of the Asian economy, given its tight trade links to China. We would not foresee a credit event in China generating the same type of dire consequences as one in the US or Eurozone, since China has relatively low external debt (at just 13% of GDP) and overseas investors generally have limited exposure.

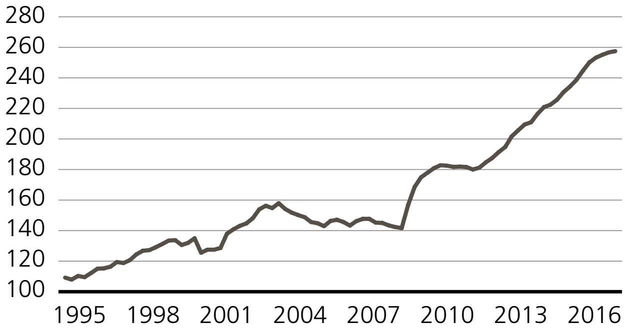
Lessons from history

China debt scares in August 2015 and January 2016 demonstrated the potential global fallout from concerns about the health of China's financial system, although in both cases Asia ex-Japan equities lagged global markets. In August 2015 Asia ex-Japan equities plunged 14.6% versus 10.4% for global equities peak to trough. In January 2016 the figures were Asia ex-Japan down 12.9% and global equities 10.6%.

Figure 2.2

Rapid Chinese debt growth in recent years

Credit to nonfinancial sector, % of GDP



Source: Bank for International Settlements

Key signposts

To assess the risk of a credit event in China we will be monitoring:

- **Regulations** on shadow financing, off-balance credit, and other non-conventional forms of credit. Plans are in motion to create a 'super-regulator', completion would signal a new, tighter regime which, while necessary, could increase the risk of execution error and slow growth.

- **Cost of borrowing:** A rise in the cost of interbank lending would be a sign of liquidity stress and counterparty default risk. Other rates to monitor include repurchase and general collateral rates, spikes in which would indicate higher costs of funding for non-bank financial institutions and would have implications for realized borrowing costs in the wider economy.

- **The National People's Congress** in March will set the macro targets for the economy, including GDP, fixed asset investment, and money supply growth. Any material downward revisions in these numbers will indicate a stronger desire to rebalance the economy away from investment growth, and could increase the chance of a credit shock in certain industries, which might struggle to refinance.

Investment ideas

- **Short CNH 12m forward, financed by CNH 6m forward:** This strategy limits carry costs while USDCNY remains stable, and should perform well if devaluation concerns resurface. In the case of a China debt crisis, investors would likely begin to price in possible downside for the Chinese yuan.

Portfolio consequences

- **Regional diversification:** Given that a China debt crisis is likely to be felt more keenly in Asia than in other regions, investors looking to reduce their exposure to China risk should ensure their portfolios are well-diversified across regions.

- **Staying invested:** China's low external debt means, in our view, that most debt scares should ultimately be manageable internally. As such, the longer-term impact would likely be limited. As in 2015 and 2016, volatility could rise temporarily, but markets would likely recover as investors came to realize that the situation could ultimately be managed through targeted regulation. It is important for investors to keep a long-term focus, and use periods of market volatility to rebalance toward their strategic asset allocation.

Regional hotspots

While our "top three" risks for the year are sharply higher US interest rates, a geopolitical shock, and a China debt crisis, they represent just a few of the "known unknowns" investors will need to guard against. Any number of "unknown unknowns" could also emerge. Diversification is the best defense against them, in our view.

North America

- **Rising interest rates:** Higher inflation could force the Fed to hike rates quickly, potentially damaging economic growth.

- **US protectionism:** Uncertainty over NAFTA negotiations, and US trade policy more generally, could lead to uncertainty among trade partners and affected companies.

Europe

- **Brexit – deal or no deal:** The UK will need to reach a "Brexit" deal with the EU by October for it to be ratified in time for the March 2019 deadline.

- **Italian elections:** An inconclusive vote could result in another technocratic government or repeat elections, prolonging business and household uncertainty.

- **Catalonia separatism:** Protests in Catalonia over independence for the region have already affected local economic growth; it could continue.

Golden Gate Bridge in San Francisco. iStock

Asia

– **North Korea tensions:** North Korea's development of nuclear weapons has raised tensions in the region and with the US, increasing the possibility of military confrontation.

– **China debt crisis:** China's rapid build-up of debt has been well-managed thus far, but high debt carries the risk of occasional flare-ups.

Latin America

– **Mexican general election:** A potential Lopez Obrador administration could cause Mexican assets to underperform.

– **Brazil election:** A populist victory in the presidential election could derail the progress made on reform and worsen the fiscal position.

– **Venezuela instability:** The country is restructuring its debt and is also scheduled to hold general elections, although it is uncertain whether they will take place.

Eastern Europe/MENA

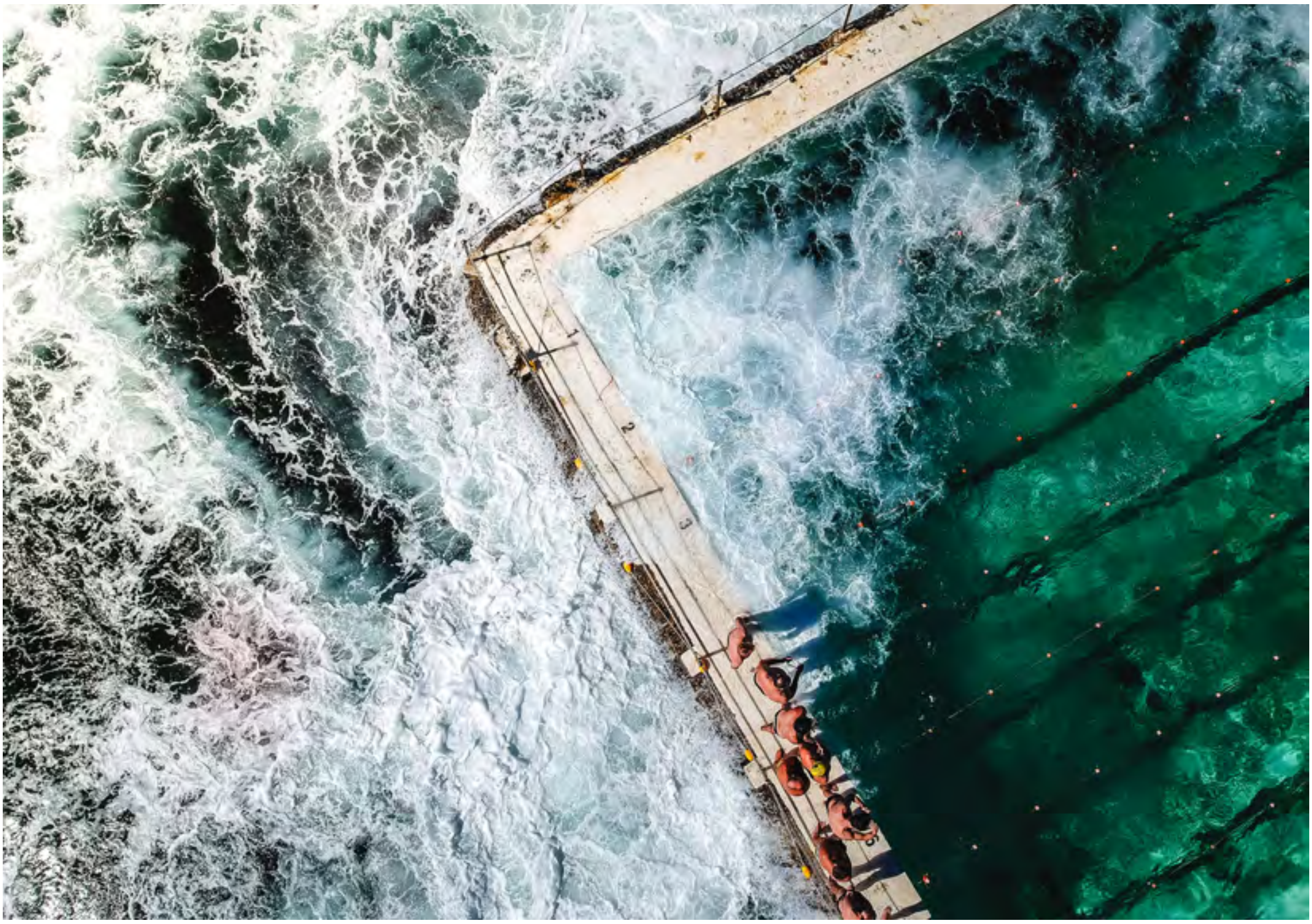
– **Saudi-Iran tensions:** Increased tensions between Saudi Arabia and Iran could cause oil prices to spike if regional supplies are disrupted.

– **US Treasury report on Russia:** Sanctions remain a key topic in Russia; any new ones imposed by the US could hurt Russian assets.

– **South Africa – ANC conference:** The country is already suffering from weak growth and a high deficit, and it is unclear whether a new leader will improve or worsen matters.

Risk Monitoring

To keep yourself up-to-date with key risks through the year take a look at our Global Risk Radar on **ubs.com/cio**


Bondi Beach, Australia. Raj Eiamworakul. Unsplash

Dealing with change

We believe that investors navigating the changing context will need to demonstrate a combination of agility, balance, and calm: the agility to take advantage of the opportunities the changing context presents; the balance to manage the risks of the inevitable monetary, political, technological, environmental, and social changes that occur; and the calm to remain focused and far-sighted in an era of information overload.

Agility

The returns on active investment strategies have generally been disappointing in recent years. But market dynamics are now becoming more conducive to them. We believe 2018 will be a year in which it will pay for investors to be more agile. Monetary tightening, political flux, and technological disruption will all present opportunities.

The returns to active investors have been disappointing

The returns to picking out favored stocks and sectors, relative to just passively investing in rising markets, have been limited in recent years. Between 2013 and 2016, more than 93% of fund managers benchmarked against the S&P 500 failed to beat the market. Loose monetary policy around the world has prompted stock prices to move in unison, rising or falling together. From 2013 to 2016, intra-stock correlations on the S&P 500 averaged 28%, versus a long-term average of 17%. In such an environment of undifferentiated stock performance, stock and sector picking is largely ineffective.

But market dynamics are changing

Today, however, market dynamics are starting to favor investors looking to take advantage of specific opportunities.

The increased share of money being managed passively is creating more mispricings relative to fundamentals, providing more opportunities for investors and managers looking to create alpha. The share of equity mutual fund and exchange-traded fund (ETF) assets that are passively managed has risen in the US from 22% in 2007 to 46% by 2017, and in Europe from 11% to 35% over the same period. USD 4.3trn of assets are now invested in global ETFs, making the market more than USD 1trn larger than the entire hedge fund industry. And this has contributed to a growing valuation dispersion that investors and managers can look to exploit. The dispersion in valuation between the cheapest and most expensive stocks is wide – at the 80th percentile of its range since 1991.

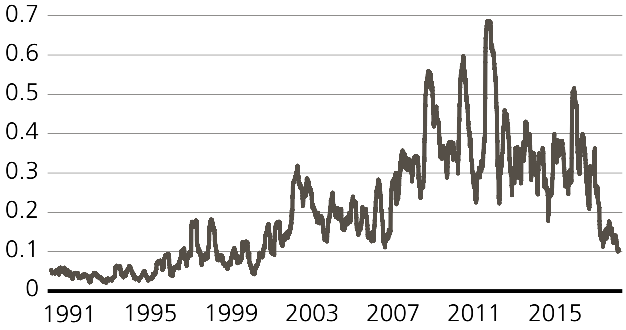
Reduced monetary stimulus is also causing specific corporate and industry developments to become more prominent drivers of stock prices, further differentiating performance. The pairwise correlation of S&P 500 stocks has fallen to its lowest level in a decade, see Figure 3.1. This shift should assist investors looking to exploit fundamental differences between stocks and sectors. From 2000 to 2016, equity long-short strategies generated average annual alpha of 6.5% or more when correlation was lower than the median.

This already appears to be having an effect on the returns of more active strategies. In the first half of 2017, 54% of managers surpassed their benchmarks. And as of mid-October, US equity mutual funds were up 16.7% for the year versus 15.7% for the S&P 500 index.

Figure 3.1

Decade-low correlations should create opportunities for agile investors

S&P 500 pairwise correlation



Source: Bloomberg

Opportunities for investors who embrace agility

These changing market dynamics give us confidence that the coming year will be one in which it pays to take a more agile investment stance by seizing market opportunities that arise from shifts in monetary policy, political developments, and technological change.

In particular, we believe rising interest rates could benefit the global financial sector. Political developments present opportunities in the US related to tax reform and deregulation, particularly in financials, energy, and healthcare sectors. Meanwhile, investors can look to take advantage of technological disruption by investing in companies benefiting from longer-term trends in digital data, automation & robotics, and smart mobility. And we still see hedge funds as an important component of portfolios, particularly so in an environment where managers are in a better position to generate alpha.

Claus Pescha. Unsplash

Balance

Holding a well-balanced portfolio is a perennial investment strategy. But the cross-currents of monetary tightening, political flux, technological disruption, and environmental and social change make keeping your portfolio in balance of particular importance this year.

Diversification across asset classes

As our themes of monetary tightening, political flux, technological disruption, and sustainability challenges play out against a backdrop of an expanding global economy, under- or overexposure to any one asset class could leave investors at risk.

Underexposure to equities might help reduce exposure to political events, but it could leave investors poorly positioned to gain from economic growth and technological developments, jeopardizing the ability of their portfolios to keep pace with inflation.

Underexposure to fixed income might prepare a portfolio well for potentially tighter monetary policy, but would also leave investors vulnerable to sharp drawdowns in the event of extreme political shocks, such as a US-North Korea conflict, in which fixed income would likely help insulate portfolios from marked declines.

Underexposure to alternatives might not appear costly during a time when bonds and equities are diversifying one another, but it would leave portfolios at risk of much higher volatility if monetary tightening causes bonds and equities to move in tandem.

We believe that holding a balanced combination of equities, bonds, and alternatives is the best way to navigate markets.

The historical evidence
In the dotcom crash, the drawdown on US equities was 46% but was just 12% on a diversified portfolio. In 2008–2009 US stocks fell 51% with a diversified portfolio down 29%.

Diversification across regions

Regional diversification will help reduce investor exposure to monetary and political risks. We expect another year of politics dominating the headlines, and see particular political risks in Brazil, Mexico, Russia, Saudi Arabia, South Africa, Spain, and the UK, while "unknown unknown" political events could occur anywhere. Investors seeking to reduce their exposure to political uncertainty can do this relatively easily by spreading investments worldwide. The impact of political events on global markets has generally proven limited or short-lived.

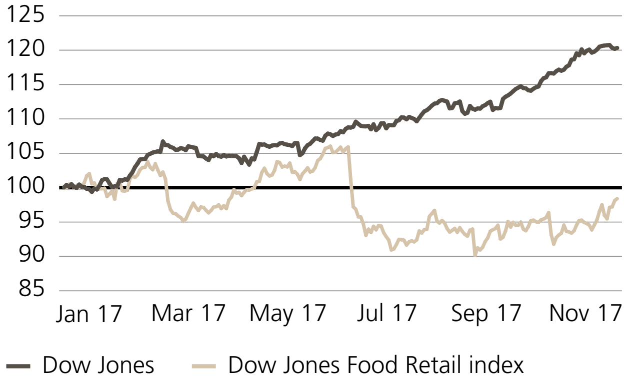
Regional diversification can also help reduce monetary policy risks. The US, UK, Eurozone, Switzerland, and Japan are all at different stages in their economic and monetary policy cycles. As such, inflation or a policy mistake, if one occurs, is likely to be localized in an individual monetary regime. Investors who hold their assets across a range of monetary regimes, while hedging currency risk, lessen their exposure to potential policy errors and rising inflation.

The historical evidence
Investors concentrated in one market have probably suffered a much bumpier ride than global investors. Since global equities plumbed their post-financial crisis trough in 2009, only one G20 stock market has exhibited lower volatility than the global MSCI All Country World index. And while the global index has not suffered a bear market decline of 20% or more since 2009, 15 of the G20 countries have done so during this period.

Figure 3.2

Disruption can affect entire industries

Dow Jones Industrial Average vs. Dow Jones Food Retail index, total return, rebased



Source: Bloomberg

Diversification across securities and sectors

Technological disruption, political change, and tighter monetary policy all increase idiosyncratic risks to individual securities and sectors. While this situation presents an opportunity to active managers and investors on the lookout for specific opportunities, it also raises the unwanted specter of underperformance for individual investors. Security and sector diversification can mitigate these risks.
This past year has illustrated the large effect these trends can have:

– The Dow Jones Food Retail & Wholesale index fell by more than 9% the week Amazon announced it would acquire Whole Foods, signaling potential technological disruption of the food retail industry. It subsequently underperformed the broader index by a further 10% over the following four months, (see Figure 3.2).

– US Real Estate Investment Trusts (REITs) exposed to the retailing sector have underperformed broader US REITs by almost 20% year-to-date, in part due to concerns about the impact of technological disruption on the retail industry.

Any unanticipated announcement in technology, politics, and monetary policy can prompt significant portfolio underperformance for investors caught in the wrong sector or security at the wrong time. Diversification across a range of securities and sectors helps protect and grow wealth over the long term.

The historical evidence
Single securities, even of apparently safe and stable companies, are fundamentally riskier than diversified holdings. Over the past three years, no S&P 500 stock has been less volatile than the index itself (S&P volatility has been 11.6%, whereas individual stock volatility has varied between 12.6% and 80.8%), and even perceived safe-havens of the Swiss market like Nestlé (15.6%), Roche (19.0%), and Novartis (20.8%) have demonstrated comparable, or higher, volatility over the same time period as the emerging market index (16.7%).

Calm

Noise and distraction are traps always ready to ensnare investors. Maintaining a long-term focus is critical and can help boost even short-term performance.

Many investors live lives engulfed by noise thanks to our increasingly connected world. Things will be no different in the year ahead. Each of our key trends will be "noisy." The end of easy money will bring with it numerous central bank meetings and pronouncements to analyze. Technological disruption promises new launches, mergers, and market entries. And political flux will spark reports of negotiations and elections, and plenty of tweets.

More information should enable investors to make better investment decisions, but too much information can also backfire and lead to poor decisions.

Individuals have a natural tendency to seek out information that solidifies their views and beliefs – confirmation bias. By unintentionally ignoring important data, investors base their decisions only on information that supports their existing beliefs. In addition, recency bias causes investors to inflate the importance of the latest report or figures they are privy to, and the herding instinct can result in the blind copying of what others are doing. In other words, investors may overemphasize information they already agree with, the latest media headlines, or what others are doing while disregarding fundamental analysis.

Instant access to market and portfolio data can both change an individual's risk preferences and lead to confusion between signal and noise. Investors who check their portfolio daily or weekly are, likelier than not, merely treating themselves to a lot of noise. For example, a fund with a very good information ratio (return-to-risk ratio) of 1x has a 86% probability of delivering positive performance over the course of a year. But the probability of positive performance over a given month is just 61%, and its chance of putting up a positive number in a given day is just 52%, (see Figure 3.3). Whether returns are positive or negative in the

Getty Images

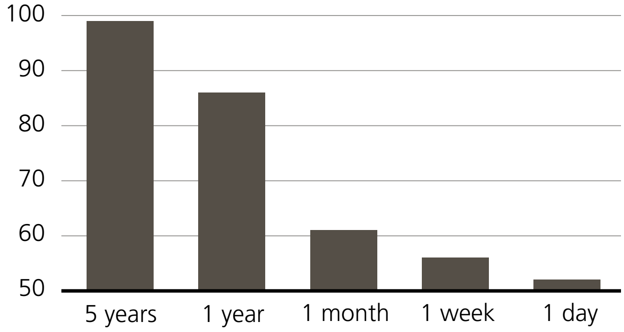
short-term is largely down to chance. Meanwhile, the act of checking will make investors confront losses more frequently, which can turn them more risk averse (and hence less able to earn returns over the long-term). This phenomenon is known as myopic loss aversion.

In addition, increased information and access to data can up the temptation to trade frequently. But evidence suggests that frequent trading hurts portfolios. A study by Barber and Odean (2000) found that average households turned over 75% of their equity port-

Figure 3.3

There is almost no useful information in daily performance

Probability of a positive return for a 1x information ratio fund over a given time horizon (%)



Source: UBS

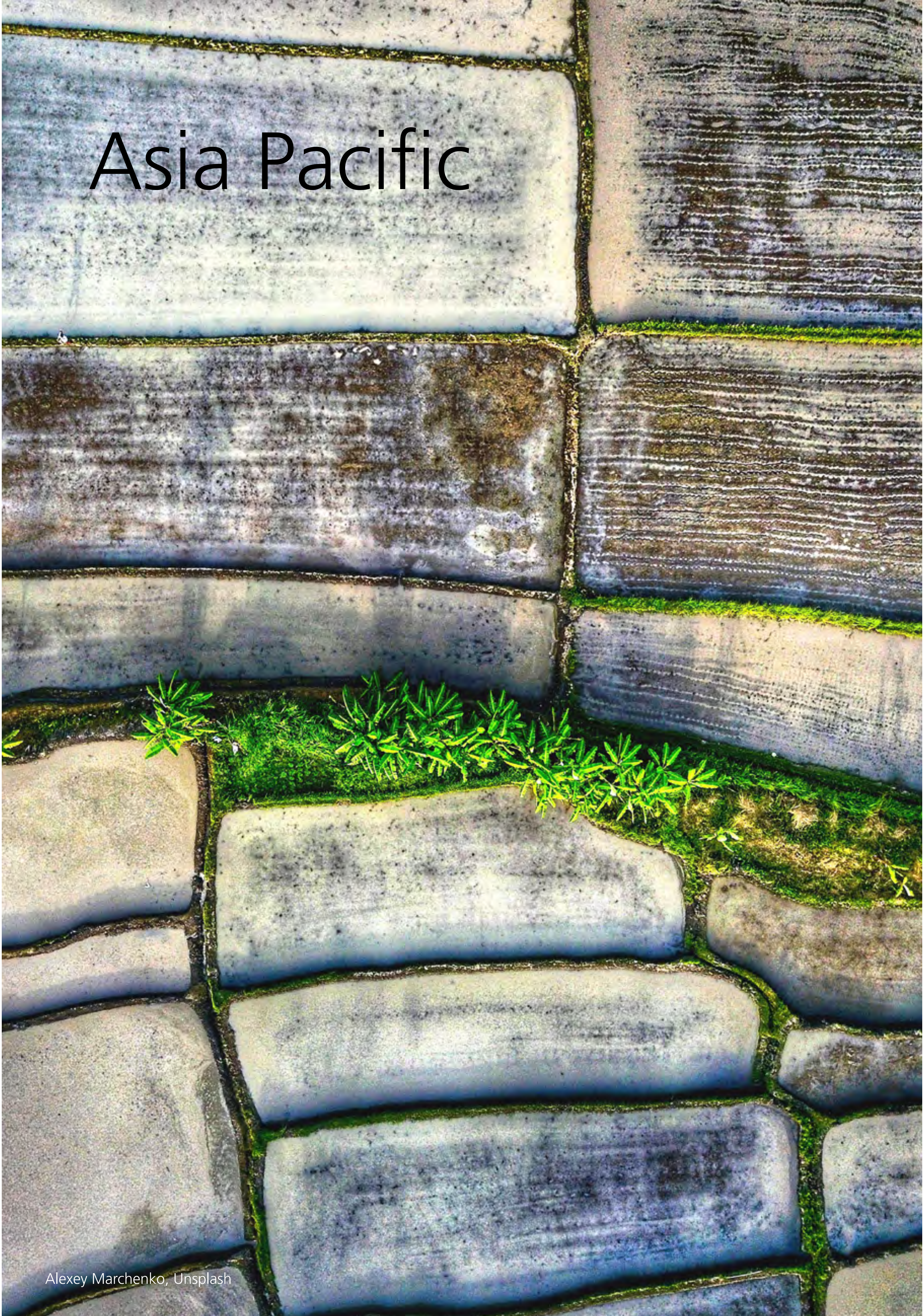
folios annually, and lost ground to a buy-and-hold strategy by 1.5% per year. Our own analysis of mutual fund investors' buy and sell decisions indicates underperformance of 0.9% annually for core equity fund investors, compared to the performance of the fund itself, between April 2007 and March 2016. Staying calm amid the blizzard of informational noise will be a key trait of successful investing in the coming year, we believe. But while awareness of the need for calm is a good start, actually behaving that way poses a greater challenge. We see three strategies private investors can use:

First, seeking out sources of information that challenge your conclusions and even your entire investing framework can help overcome confirmation and recency bias. In our investment process, we incorporate the UBS Investor Forum to allow external asset managers to challenge our views.

Second, fixing regular but infrequent times to check your portfolio can reduce your exposure to noise, which might otherwise be mistaken for a signal. Provided your investment portfolio is well balanced, there is little to be gained from checking it too regularly.

Third, it's crucial to remain patient and disciplined. The start of the year is as good a time as any to carefully think through an investment strategy: how to allocate strategically to fulfill goals and ambitions, how much to deviate from the long-term plan to seize unexpected opportunities, how to behave in the case of drawdowns, and how frequently to rebalance. Sticking to your plan once you've determined it is a key part of long-term investing success. The wrong strategic allocation, portfolio drift, and, most importantly, not staying invested are among the main causes of wealth destruction over the long term.

Asia Pacific



Alexey Marchenko, Unsplash

Asia in 2018: Playing the mid-cycle

Asian markets rose strongly in 2017, notching up their greatest gains in eight years as the recovery in trade and corporate profits lifted regional activity. Upside surprises to economic growth, downside surprises to inflation, and China's steady policy hand helped sustain the regional rally amid tensions on the Korean Peninsula and a volatile US political climate.

Before investors position for 2018, they need to address some key questions: Where does Asia stand in the economic cycle? Can China continue to balance reform and growth? Will innovation occupy the driver's seat? How will the recent increase in oil prices and narrowing output gaps affect inflation, monetary policies, and exchange rates?

We're positive on the economic outlook and are keeping a risk-on stance as we head into 2018, but the uncertainties about monetary policies and geopolitics mean that investors should ensure they hold a well-diversified strategic asset allocation.

Where is Asia in the economic cycle?
We think it is in mid-cycle. Growth is leveling out and the focus is shifting from trade recovery to investment and domestic consumption. Chinese investment should moderate, but we expect Southeast Asia to spend more and real investment growth to accelerate. Inflation should rise as higher oil prices push through to headline prices and greater investment and narrowing output gaps lift core measures. Asian central banks will likely turn more hawkish and gradually raise rates from 2H18.

Can China keep balancing reform and growth?

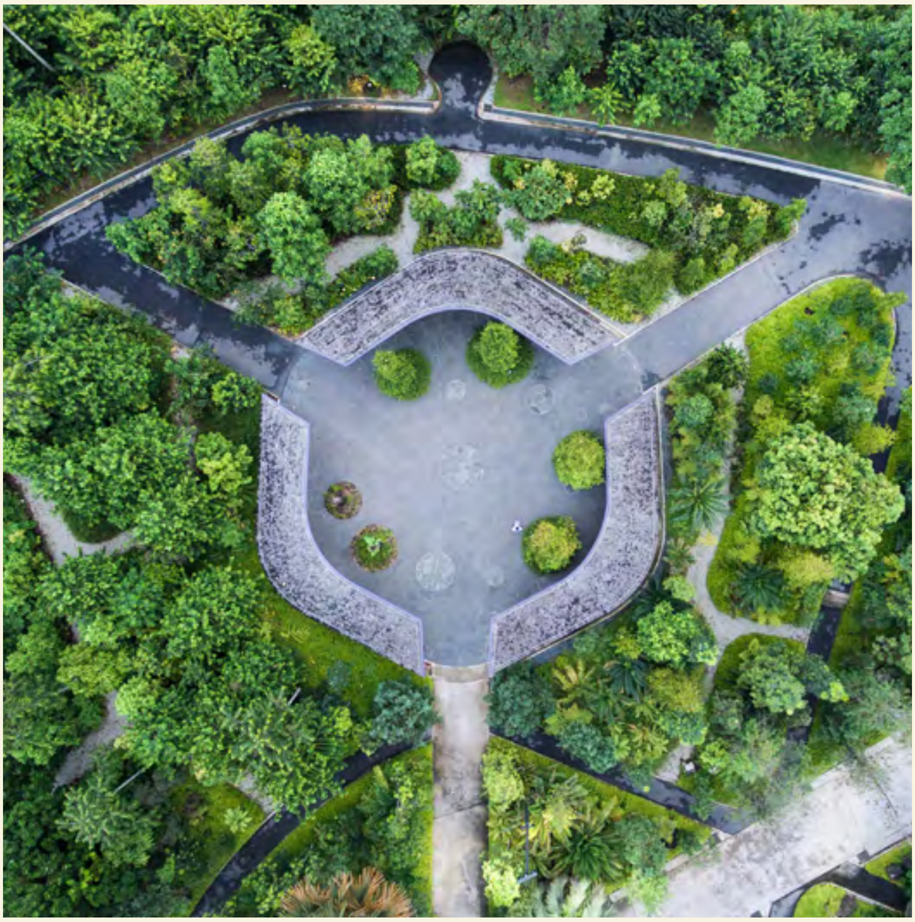
At the 19th Party Congress, Chinese President Xi Jinping consolidated his power further and re-emphasized his "Chinese Dream" of the country becoming a fully modernized socialist state by 2035 and a leading global power by 2050. He also affirmed China's commitment to pursuing structural reforms while deleveraging and containing financial risk, and stressed the need for higher-quality growth.

Environmental protection, state-owned enterprise (SOE) reforms, and capacity reduction plans will likely broaden out over the coming year, while the liberalization of domestic markets will be gradual. Other priorities include becoming an innovation leader and the Belt and Road Initiative – Xi's strategic platform to project China as a responsible superpower.

GDP growth should moderate to 6.4% in 2018. Downside risks include a slowing housing market and a breakdown in China-US relations, although the latter appears remote.

Is innovation Asia's next driving force?

We expect innovation to fuel Asia in the year ahead and beyond. The region has rapidly narrowed the innovation gap versus developed markets thanks to a swift rise in tertiary educated workers, greater research and development (R&D) spending, and pro-innovation policies. China's R&D outlay will likely exceed the US's in 2018, and Asia will likely overtake the US and EU combined by 2020. Innovation in areas like the environment, automation, robotics, and healthcare, as well as in niche consumer applications, could accelerate Asia's economic transition, lift pricing power, and raise the prospects of a further rerating.



Singapore Park, Singapore. iStock

Asia's mid-cycle opportunities in equities, bonds, and real estate

Asian equities should again outperform bonds

We believe the trend strength in Asia ex-Japan equities can continue. We overweight them relative to US investment grade bonds due to their region's earnings momentum, discount to global peers, and modest re-rating potential. We remain overweight China, Indonesia, and Thailand. Malaysia, the Philippines, and Taiwan are underweights. We are also overweight the J.P. Morgan Asia Credit Index (JACI) high yield (HY) versus JACI investment grade (IG), but are neutral on Japan in our global tactical asset allocation.

Earnings should broaden beyond technology and North Asia

We expect Southeast Asian markets and India to catch up with North Asia, and see consumer laggards making gains against early cyclical stocks in 2018. We remain upbeat on regional banks. Earnings growth for cyclical technology may decelerate, but the internet's structural story is intact. Select consumer stocks in Indonesia, Malaysia, and Thailand are preferred.

Be selective in Asian credit given expensive valuations

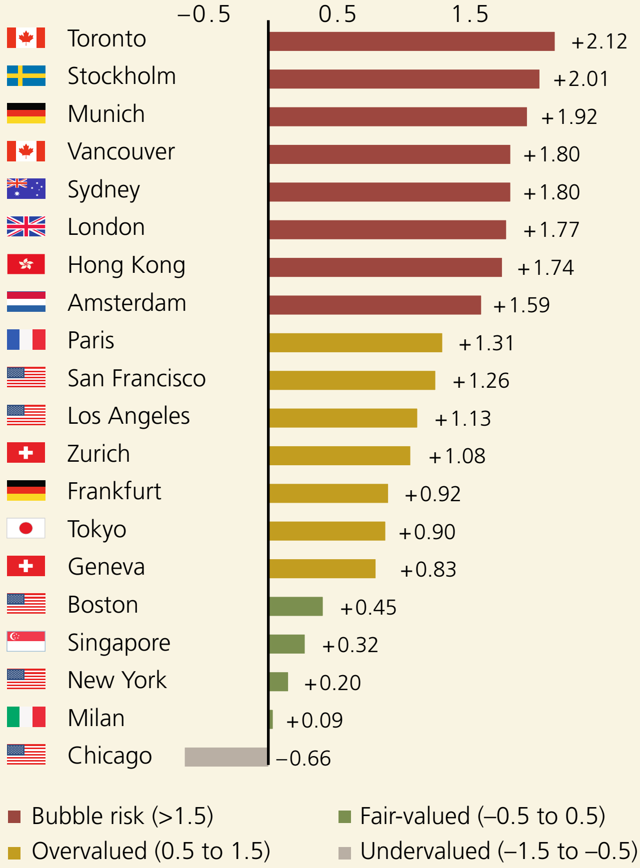
Asian credit returns should be limited to a carry of 3–4% in 2018. We do not expect major spread widening, however, in light of the stable fundamentals and strong technicals. We like select corporate hybrids, non-rated Hong Kong/Chinese issuers, and short-dated Chinese industrial bonds. In the Chinese property sector, IG BBB and large-scale BB developers are preferred over high yield.

Asian currencies should appreciate moderately
Stronger inflation readings, a persistent Asia-US growth differential, and euro strength should support Asian currencies. Against broader USD weakness, we think the People's Bank of China (PBoC) will guide the USDCNY lower and forecast the pairing at 6.5 by the end of 2018.

Asian real estate outlook varies by country
Hong Kong remains in bubble territory but is stable, in our view; Tokyo is still overvalued and the market has likely peaked; Singapore is fairly valued and is the only Asian market where we see a gradual recovery; and we expect China's property market to adjust lower after it cooled in 2017 (see UBS Global Real Estate Bubble Index).

UBS Global Real Estate Bubble Index

Latest index scores for the housing markets of select cities



Source: UBS, as of September 2017

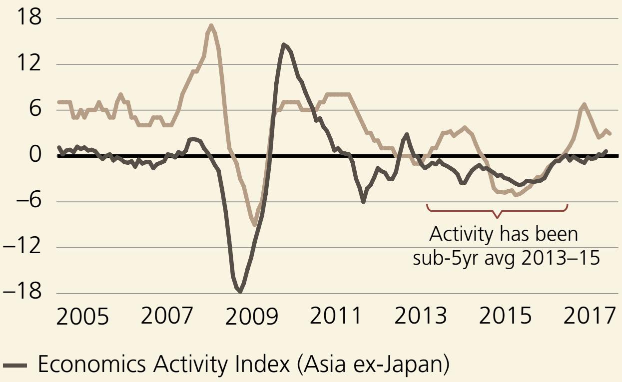
Where is Asia in the economic cycle?

Asia in 2017 was mainly a story of continued trade recovery and better pricing power. We think 2018 will be one of broader investment and credit growth. Greater demand should lift inflation and, along with US monetary tightening, trigger APAC rate hikes sometime in 2H18.

Figure 4.1

Economic Activity Index moves above trend

In % y/y (relative to five-year average)



Source: CEIC, UBS, as of October 2017

Macro outlook: The order matters

Asia is entering the middle stage of its economic expansion, which we see following an economic sequence of rising investment and credit and then rate hikes. The pace of economic expansion will no longer accelerate, in our view, and will settle at 6.1% (the same as in 2017). Pricing power improved, trade continued to recover, and Chinese investment and credit boomed in 2017. In the coming year, the focus will shift, we believe, to a broadening of investment and credit growth in South and Southeast Asia, along with greater Chinese consumption.

In 1H18, easy monetary policies, robust global demand, and positive carry-over activity in China thanks to the investment and credit boom should keep the region humming. The investment and credit story is likely to broaden out more to South and Southeast Asia, and our Asia economic activity index should remain at or above trend (see Figure 4.1).

The story by the second half of the year should involve a subtle yet important difference with central banks shifting to tighter monetary policy. Greater consumption, investment, and credit growth regionally and tighter output gaps should prompt a pickup in employment and wages, while the second-

Thailand. iStock

round effects of higher oil prices are likely to start fanning core inflation. Upon recognizing these trends, central banks should shift to a more hawkish stance and hike rates shortly thereafter.

That said, like for the G10 central banks, this normalization process will be gradual. We anticipate hikes in the vicinity of 25–50bps, enough to moderate activity somewhat as the cost of capital rises. Our activity index will likely slip to trend or slightly below it during this period, but healthy corporate and household balance sheets should prevent a pronounced slowdown.

Investment and credit to broaden out

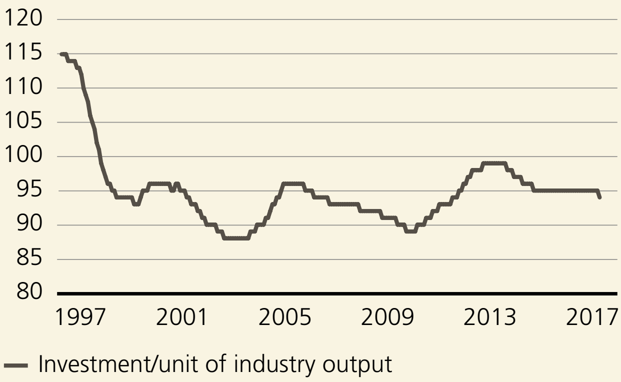
While the pace of investment and credit in China should moderate, it will likely accelerate in South and Southeast Asia. The ratio of investment per unit output in Asia has declined since 2013 as many companies cut back on capacity amid sharp drops in producer prices (see Figure 4.2). While 2017 brought stabilization to the region as investment kept pace with output, the conditions are in place for real investment to accelerate (from 5% to 8–9%), in our view. This should become visible as investment per unit output rises, similar to what happened during the dotcom boom, the early 2000s, and 2011–13.

Factors supporting investment include greater profitability, lower real interest rates (nominal rates minus inflation), more robust bank balance sheets, and proactive government policies such as China's Belt and Road Initiative. New industrial themes (i.e. IT, artificial intelligence, and robotics) should help, while the recovery in infrastructure investment is already underway, especially in parts of Southeast Asia.

Figure 4.2

Investment has stabilized per unit output, set for an upturn

Index 2005 =100 (12mma)



Source: CEIC, UBS, as of October 2017

Shanghai, China. iStock

Inflation takes center stage

Inflation is set to be the next major topic for investors. Asian consumer price inflation (CPI) was dormant in 2017. But in the coming year and beyond, increased demand should rejuvenate Asian CPI, which we believe could rise by 0.5–1%, as a policy issue. But greater investment and credit are important preconditions.

These conditions should motivate central banks to begin hiking interest rates. But overly aggressive rate hikes can quickly generate politically unpopular exchange-rate appreciation pressure in Asia's small, open economies, particularly during periods of USD weakness. So we think the banks may gently tighten monetary policy by allowing moderate appreciation in exchange rates – by an average of 3% relative to the USD.

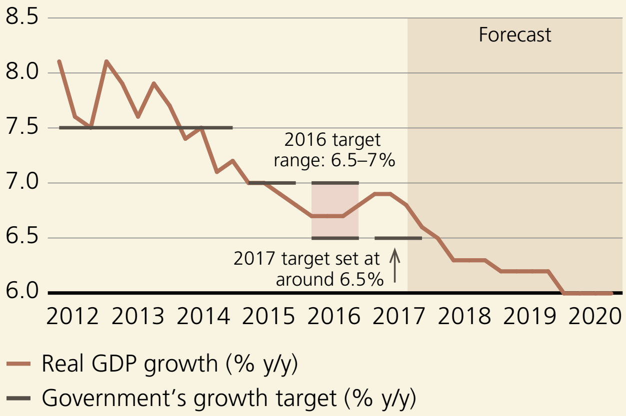
What are the implications of the "Chinese Dream"?

China will maintain its policy direction, push for reforms to ensure quality growth, further open its onshore market, and step up its role in shaping the geopolitical environment in the year ahead, we believe.

Figure 4.3

China government is putting a growing emphasis on the quality, rather than quantity, of growth

Growth in % y/y



Source: NBS, UBS, as of September 2017

A new era of socialism with Chinese characteristics

President Xi Jinping coined the phrase "Chinese Dream" shortly after he took office in 2012 and embarked on his quest to achieve "the great rejuvenation of the Chinese nation." Five years on, after further consolidating his power at the 19th Party Congress, he has announced the start of a new era of socialism with Chinese characteristics, reiterating his vision for China to become a modernized socialist state by 2035 and a leading global power by 2050.

At home: Reform and rebalancing; quality over quantity

Xi's goal of doubling per capita GDP by 2020 (from the 2010 level) appears in sight (see Figure 4.3). But Chinese leaders have subtly de-emphasized specific long-term growth targets beyond 2020, simply stressing the need for quality growth. We believe this ambiguity gives policymakers more scope to press ahead with reforms.

An industrial upgrade and environmental protection are embedded in the government's pursuit of quality and sustainable growth. China's eight million college graduates yearly will shift its demographic dividend from labor quantity to quality. This should facilitate an industrial upgrade to skill-based, high-end manufacturing and innovation-based modern services, bolstering growth in the coming decades. Also, we expect environmental regulations to tighten.

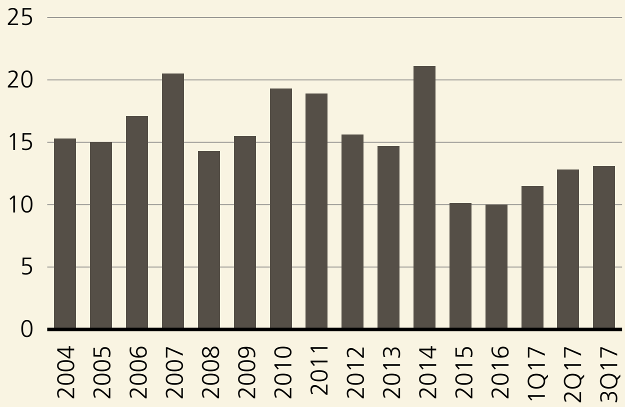
Deeper state-owned enterprise (SOE) and supply-side reforms in the context of capacity reduction and deleveraging will be critical for China's ongoing economic transition (see Figure 4.4). Some measures are already in place, but more needs to be done to address the structural imbalance and sustain growth. We foresee the scope of reform and deleveraging efforts broadening in 2018, expanding from coal and steel to other upstream sectors, from the financial industry to the real economy, and from SOEs to local governments and private sectors.

Overseas: Step up and open up
China is much more important to the world now than ever before. This increased importance stems not just from the size of its economy but also from its growing global influence. Political uncertainty in the US and Europe is also leaving a void in global leadership for China to fill. The Belt and Road Initiative, Xi's strategic platform to project China as a responsible superpower, suggests greater involvement in shaping the current geopolitical environment.

Figure 4.4

SOE and supply-side reforms have helped corporate China's return on equity to bottom out since 2016

Average ROE of CSI 300 ex financials, in %



Source: Wind, UBS, as of September 2017

Despite capital controls, the yuan's internationalization has not slowed. Among its recent examples are China's loosening of foreign ownership limits on financial companies, the increased use of the yuan as a reserve currency (following its inclusion in the IMF's "special drawing rights" basket of major currencies), the launch of CNY-denominated oil and gold contracts, and the extension of China's bilateral currency swap agreements with various countries. Also, MSCI's inclusion of Chinese A-shares into its benchmark indexes next year should prompt greater foreign participation in China's onshore capital market, as China's weighting in global investors' portfolios is currently only 3%.

China-US ties are arguably the most important bilateral relationship in the world and a cornerstone for the new global geopolitical structure. Mutual efforts have been made toward smoother relations, but challenges remain and a temporary escalation in tension is possible. The two countries' interests are deeply intertwined, and we expect a win-win solution to be reached, which should limit potential fallout from trade disputes.

China: Steady as she goes

CIO's base case for China calls for policy continuity, with economic reforms supporting an orderly growth slowdown. We expect monetary policy to be neutral and prudent, meaning liquidity will remain stable despite continuous regulatory tightening. Fiscal policy should stay supportive, with infrastructure investment serving as an important buffer for economic stability.

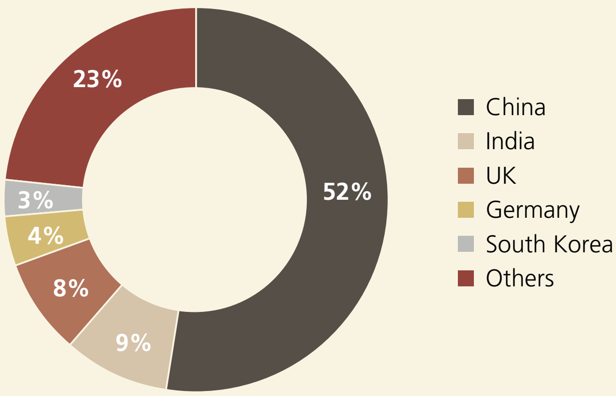
Is innovation Asia's next driving force?

Asian innovation is at an inflection point. More companies are moving up the value chain and posting superior margins and sustainable growth. We think this will help the region re-rate and accelerate the shift from old to new economy-fueled growth.

Asia's innovation ascent has just begun
Asian firms dominate the list of "unicorns," or unlisted start-ups valued at more than USD 1bn, located outside of the US: out of the 106 non-US unicorns (source: CB Insights), China accounts for 52% of them, or 55 companies, followed by India (9%) and South Korea (3%) (see Figure 4.5). Asian companies have succeeded in moving up the value chain. And the region now features global leaders in many industries beyond technology, like environmental technology, automation, new materials, pharmaceuticals and medtech, niche consumer applications, and emerging areas like fintech/insurtech and autonomous driving.

Figure 4.5

Asia dominates the global (ex US) list of unicorns



Source: CB Insights, UBS, as of September 2017

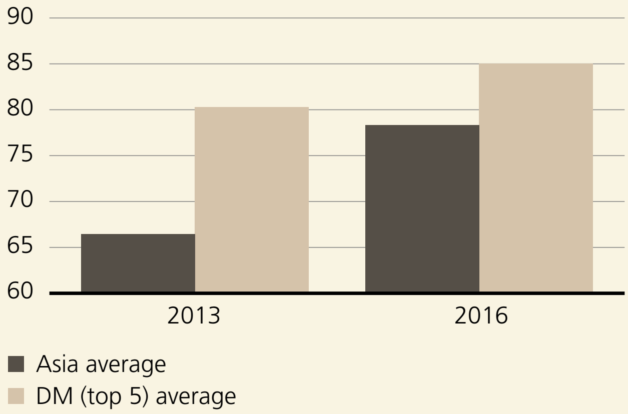
Asian innovation is at a turning point, in our view, and we expect it to lead to improving pricing power, rising margins, and, in turn, sustainable profit growth in the next few years. Our positive view stems from Asia's rapidly narrowing innovation gap relative to developed markets, which should accelerate Asia's shift from old to new economy (see Figure 4.6).

Bloomberg's average innovation score for Asia rose from 66.5 in 2013 to 78.3 in 2016, versus the developed market (top five) average of 80.2 in 2013 and 85.0 in 2016. We expect China's R&D spending to overtake the US's in 2018, and Asia to exceed the combined R&D spending of the EU and the US by 2020.

Figure 4.6

Asia's innovation gap against developed markets should continue to narrow

Innovation score (on a scale of 0–100)



Note: DM (top 5) is the average innovation score of Sweden, US, Germany, Switzerland, and Finland

Source: Bloomberg, UBS, as of September 2017

Three pillars support Asia's innovation rise

The first pillar powering Asia's emergence as an innovation power is its growing talent pool. Access to such a vast and affordable talent pool acts as a major competitive advantage for the region, in our view. A case in point is that R&D employees constitute 45% of total staff at Chinese internet companies, versus 25% for their US peers.

The second is increasing access to capital and R&D spending. Asia's innovation centers are starting to rival Silicon Valley, while Asian companies are designing successful business models and attracting numerous venture capital (VC) investments. Also, as highlighted in our October edition of *Investing in Asia Pacific*, Asian firms are reducing capital expenditure intensity and shifting their spending toward areas like R&D, helping expand their margins.

And the third pillar is favorable government policies that aim to boost companies' innovation capabilities. They include China's "Made

Shanghai, China. iStock

in China 2025" initiative, India's "Digital India" roadmap, Japan's push for a cashless society ahead of the 2020 Olympics, and Singapore's "Smart Nation" plan. All of these programs aim to support innovation-based business models and ease the economic transition toward new economy-based sectors by generating employment.

How to invest in Asian innovation

Investors should target innovation leaders in new economy sectors, as well as companies in the old economy embracing innovation. By region, North Asia should continue to dominate this innovation story, as Southeast Asian markets – excluding Singapore and to some extent Malaysia – are lagging their northern peers. While India holds promise in sectors like healthcare and IT services, its innovation ecosystem needs to grow before it can reap the benefits, in our estimate.

For thematic ideas, we recommend our Longer Term Investment themes. For example, our "Automation & robotics" theme features Japanese companies that produce industrial-use robotics, production of which rose 26% in 2017 as total sales reached a record high of JPY 50bn a month. "Smart mobility" is also a promising trend as electric vehicle sales in China alone are expected to rise four-fold to two million units by 2020. Also, Asian companies exposed to our other themes like "Education services," "Emerging market healthcare," "Energy efficiency," "Insurtech," "Internet of Things," and "Renewables" should grow alongside the region's emerging innovation process.

Where are we in the Asian real estate cycle?

We are relatively cautious on China and Japan, and expect a gradual recovery in Singapore and a stable market in Hong Kong.

Singapore: Gradual recovery

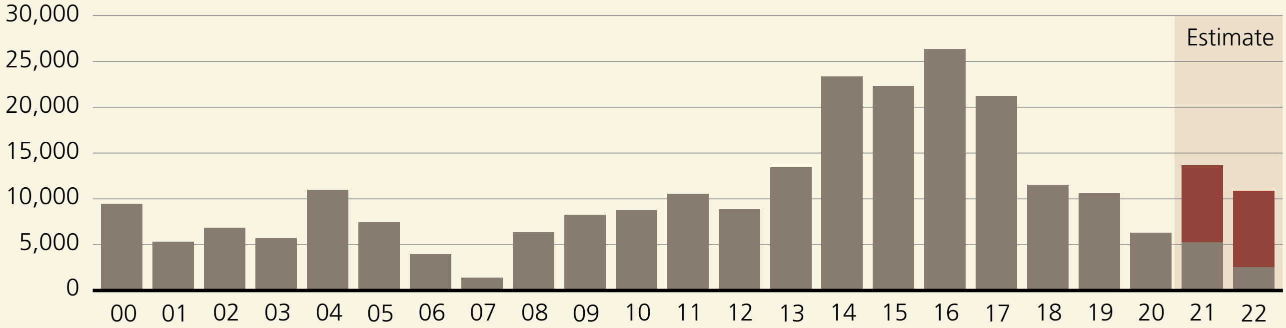
Sentiment in the residential property market finally picked up in 3Q17, after prices had declined for 15 straight quarters (or a cumulative 12%). Volumes in the primary market surged, boosting the secondary market. Developers have also started to aggressively replenish their land bank. Tweaks to the property-tightening measures in March 2017, better affordability with mortgage loans pegged to fixed deposit rates instead of interbank rates (which are higher and more volatile), and a gradually recovering economy have reinvigorated the market.

The recent spate of en bloc activity will likely reboot residential supply by late 2019, coinciding with higher US interest rates (see Figure 4.7). Pent-up demand is driving a near-term recovery, but an exuberant rebound is unlikely due to anti-speculative measures and low population growth. Meanwhile, job creation remains lackluster.

Figure 4.7

While oversupply is less of an issue now, strong en bloc activity could increase it from 2021 onward

New housing supply for private residential (incl. executive condominiums)



■ URA estimates an additional 16,700 units could be made available for sale in the next 1–2 years, and completed from 2021 onward

Source: MND, URA, HDB, Parliament reports, UBS estimates, as of 31 October 2017

The office and industrial sectors are recovering on the back of the improving economy. Prime office rents should continue to benefit from a flight to quality in 2018, but industrial rents are expected to see only a modest rebound. The retail space remains under pressure due to the migration to online shopping and a relatively strong SGD.

Hong Kong: Stability ahead

We expect a stable residential property market over the next 12 months. Demand is bolstered by a low unemployment rate, low mortgage rates, and robust buyer interest (both local and foreign). The expected supply of about 22,000 primary units in the 2017–19 time frame is not excessive, in our view. We are less concerned about rising mortgage rates as many Hibor-based mortgages have interest rate caps of around 2.15%, and competition among banks could further pressure mortgage rates. Though housing affordability may be the worst it's been since 2000, positive fundamentals should cap any meaningful downside in the near term.

We are positive on the Central office market, given its healthy momentum in rentals both in the near term (thanks to robust Chinese demand, a sub-2% vacancy rate, and limited new supply) and the medium term (courtesy of Greater Bay Area initiatives).

Japan: Turning cautious

After five years of recovery, the Japanese property market is near its peak, in our view. We hold a cautious view on it and recommend selectivity as prices are high. Residential property prices peaked in 2Q17 (+27% since 3Q12), and they have led to reduced affordability. Vacancy rates in Tokyo's office sector are historically low (3.02% in September) due to solid office floor space demand. But new office supply is likely to increase from 2018, which should raise vacancy rates and hurt rents.

Demand for logistics facilities continued to grow in 2017. Net absorption hit a record high, and rents held up amid stable occupancy. But supply in Tokyo and Osaka is expected to increase in 2018, so we are less optimistic. The large-scale conversion of urban farming land into housing from 2022 due to tax incentive changes is a risk.

China: Soft landing, continuous adjustment

Tighter housing policies gradually cooled China's property market in 2H17. Housing prices, sales, investment, floor space started, and land purchased all decelerated, and we expect this trend to continue. President Xi Jinping reiterated that "housing is for living rather than for speculation" at the 19th Party Congress, highlighting the government's goal of a healthier housing market. Key measures include restrictions on housing purchases and sales, controls on mortgages and loans to developers, an increased supply of low-rent housing, and a possible property tax in more cities within the next two years. The property market is likely to land softly thanks to continuous adjustments; we expect it to consolidate, with the top 100 developers gaining over 60% market share over the next 5–10 years from less than 10% currently.

Tactical Asset Allocation: Entering the new year tactically bullish

The most synchronized global economic pickup since 2010 continues to provide a highly supportive macro backdrop for global equities. We enter the coming year with a risk-on stance as we see upside for Asian and global equities. But we expect the ride to become bumpier, with potential for larger setbacks as the year progresses.

A reversal of a seven-year cold spell

From 2010 to 2016, Asian investors experienced the longest streak of underperformance versus US stocks in recent history. The synchronized global growth recovery finally snapped this seven-year cold spell. But we expect the reflation trade to soften as economic growth shifts from acceleration toward steady expansion in 2018. Still, we believe the normalization in the risk attitude of the private sector and its impact on markets will spur domestic demand. This should offset the drag from the counter-cyclical reduction of the Federal Reserve's monetary policy support.

Investment pickup the next phase

So, the next phase of this expansion should be driven by a meaningful pickup in private investment growth. Stronger aggregate demand and rising corporate pricing power are driving an increase in Asia ex-Japan (AxJ) earnings that has led them 22% higher so far in 2017, with analysts having upgraded their 2018 earnings forecasts for 17 consecutive months. We believe this equity rally is supported by fundamentals as most of the gains have stemmed from earnings, not multiple expansions.

While we entered 2017 with an overweight on AxJ equities, we locked in profits during the year and have been tactically focused on alpha generation with big-market calls like our overweights on China and global equities. As further evidence emerges that this cycle is more resilient than others in recent history, we are moving back to a tactical overweight on AxJ equities by reducing the allocation to US investment grade bonds (see Figure 4.8).

Thanks to the solid macro environment and strong earnings momentum, we are positive on Asia: it trades at a double-digit discount rate to its global market peers and may be due for another re-rating.

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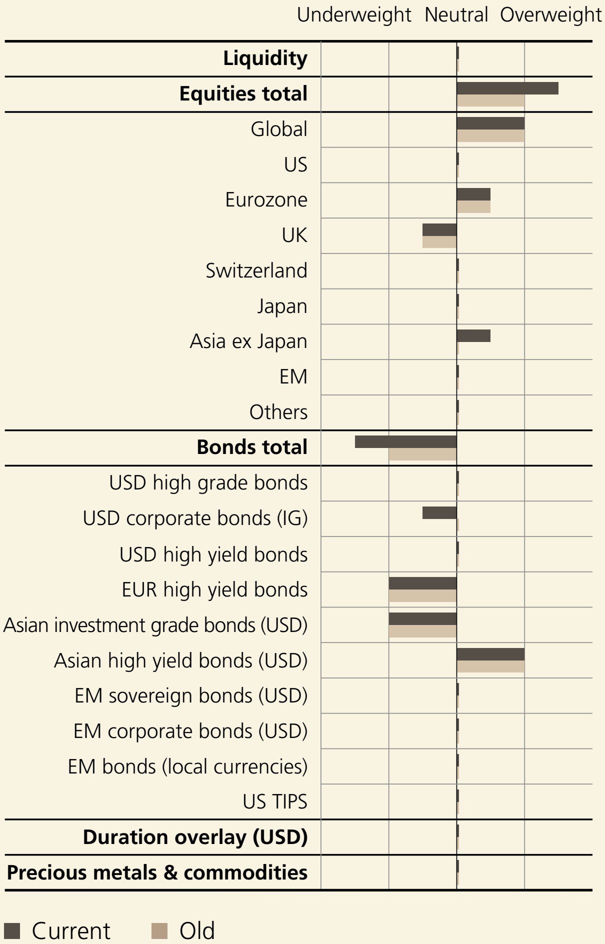
Figure 4.8

APAC-focused tactical asset allocation deviations from benchmark



Source: UBS, as of 16 November 2017

Overweight China and Asian high yield bonds

We remain overweight offshore Chinese equities (see Figure 4.9). China is managing its monetary tightening in a way that will allow for a gradual slowdown, in our view. Despite its focus on leverage in shadow banking and the brakes being applied to off-balance sheet lending, its overall credit and monetary bases are still growing moderately. While the country's economic growth is likely to slow in 2018, its economic base is significantly higher than it was a decade ago, and supply-side reforms are boosting state-owned enterprise profits.

This environment also offers support for Chinese high yield (HY) bonds, which account for half of the Asia HY index. With their credit metrics having improved amid better earnings, cash flow, and debt coverage, we are staying overweight on JACI HY bonds relative to their investment grade peers.

Outside of China, in Asian equities, we are overweight Indonesia and Thailand (see Figure 4.9). Both markets should benefit from a recent commodity recovery that is likely to boost earnings. We are underweight Taiwan as we believe that earnings forecasts for Taiwanese companies are too optimistic and could lead to relative underperformance. Likewise, we are underweight the Philippines and Malaysia: we consider market expectations for both to be too high given the domestic macro headwinds they face.

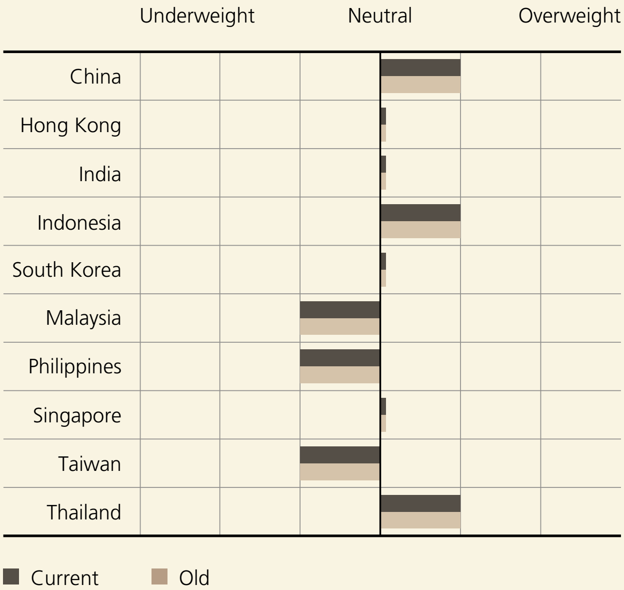
Be risk-on but diversified

Vigorous global growth and mild inflation bode well for markets going into 2018. We expect global liquidity conditions to peak as several major central banks reduce support, however, so market volatility is poised to revive. Overcoming the fear of setbacks and benefiting from the comeback of Asian markets in the coming year is best accomplished, we believe, by owning a globally diversified portfolio with a focus on Asia. It should mitigate the anticipated risks without compromising potential returns.

Figure 4.9

Asia ex-Japan equity strategy (relative to MSCI Asia ex-Japan)

Country preferences within Asia ex-Japan



Source: UBS, as of 16 November 2017

* Please note that the bar charts show total portfolio preferences and thus can be interpreted as the recommended deviation from the relevant portfolio benchmark for any given asset class and sub-asset class. The UBS Investment House View is largely reflected in the majority of UBS Discretionary Mandates and forms the basis of UBS Advisory Mandates. Note that the implementation in Discretionary or Advisory Mandates might deviate slightly from the "unconstrained" asset allocation shown above, depending on benchmarks, currency positions, and other implementation considerations.

Bonds: Cautiously carrying on

We expect Asia credit spreads to be range-bound and total return to be 3–4% in 2018. We see value in select Hong Kong and China non-rated names, corporate perpetuals, and short-dated China industrial bonds. We avoid single A or longer-duration bonds.

Total return limited to coupon carry
We expect Asia credit total return in the coming year to be limited to coupon carry (3–4%), compared to 2017 (5.8%). Rising interest rates should dampen Asian credit performance, but their impact should be partly offset by stable fundamentals and firm market technicals. Credit spreads are likely to remain range-bound despite historically tight valuations, and we expect the JACI Composite Index to trade within a 215–235bps range (vs. 225bps currently). The key drivers for credit spread movement are likely volume and the timing of new issue supply. Gross supply for 2018 should exceed 2017's by 10% to reach a high of USD 290bn, in our view, with Chinese issues accounting for two-thirds of it.

Mild rise in interest rates, rates curve to continue flattening
The decline in longer-term US interest rates benefited Asia credit performance in 2017. We expect the Fed to hike rates by 25bps twice in the year ahead, and US interest rates to rise for the longer term. We forecast the 10 and 30-year US Treasury yields to move up to 2.5% and 3.1% respectively, and the 2-year versus 10-year Treasury yield spread to tighten to 50bps from the current 80bps, resulting in a further flattening of the yield curve.

The investment implications of a flattening yield curve are twofold: First, the rise in front-end interest rates without a commensurate rise in longer-term rates will likely render carry trade strategies less attractive as the yield pickup compresses. Carry trades involve the purchase of longer-dated bonds financed by short-term borrowing. As such, we are cautious on high-quality A and AA rated bonds with tight credit spreads. Second, we expect a bigger supply of longer maturity bonds for both investment grade (IG) and high yield (HY) as companies capitalize on the flat yield curve to lock in borrowing costs for a longer period.

Valuations remain expensive, but major spread widening unlikely in the near term

The valuations for IG and HY (at credit spreads of 160bps and 438bps respectively) are historically tight and unlikely to tighten further (see Figure 4.10). A sharp 40–60bps widening is equally unlikely as the market remains strongly bid by local Asian investors, in particular the Chinese. The participation by Asian investors in Asia USD bond deals has risen to 80% from 60% of total volume in the past five years. USDCNY's recent move to 6.63 due to an appreciating yuan is unlikely to deter Chinese investor demand for offshore USD assets as the flows are structural for the most part and arise from currency diversification needs.

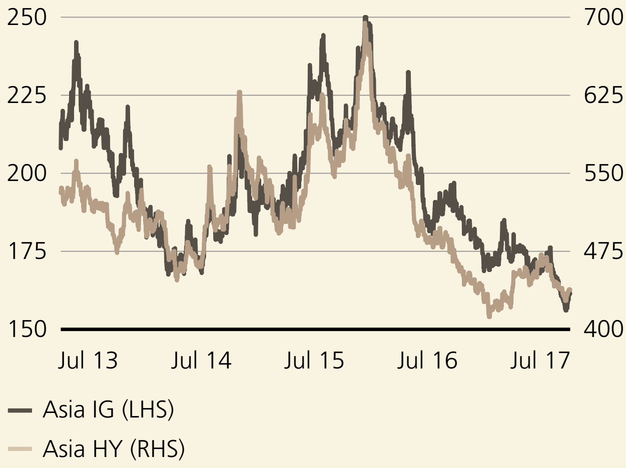
Chinese property fundamentals likely to peak

China's property sector credit fundamentals will peak in 1H18, we believe, as earlier robust pre-sales can support earnings until 2H17. We expect restrictive housing policies to continue, dampening property sales and developers' cash flows (see Figure 4.11). Outside the sector, we remain sanguine on the credit fundamentals of Asian issuers as a whole. Credit quality has improved fundamentally in core sectors such as cyclicals and banks. Cyclical sectors such as metals and

Figure 4.10

Asia credit spreads at historical tights

In bps

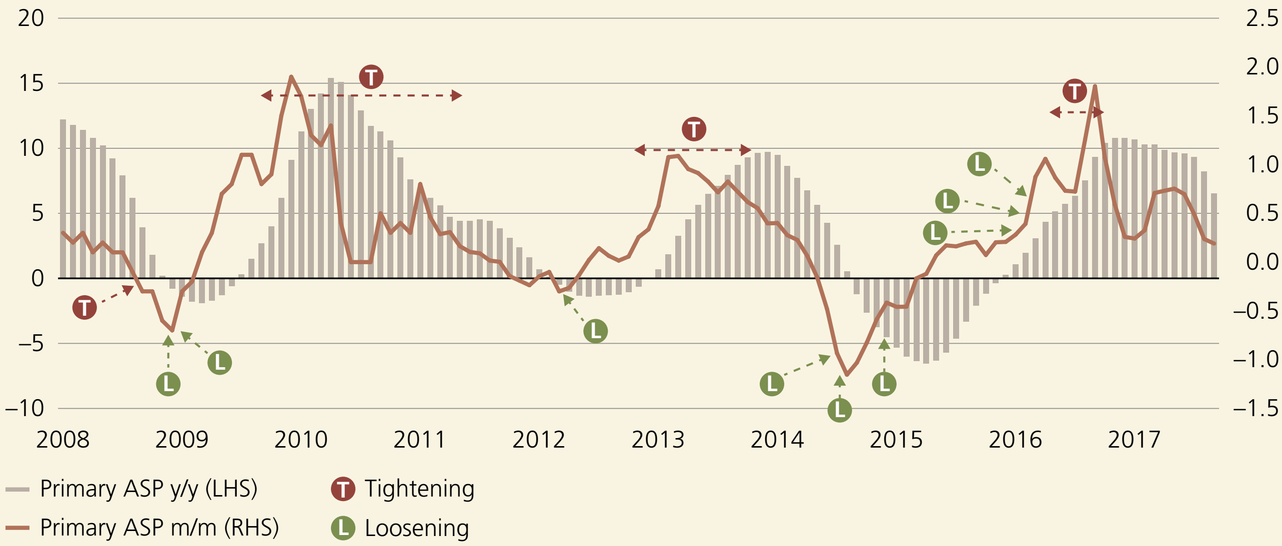


Source: JP Morgan, Bloomberg, UBS, as of 2 November 2017

Figure 4.11

China housing policy tightening usually lasts 2–3 years

% change in average selling price



Source: CEIC, UBS, as of 2 November 2017

mining benefited from the rebound in commodity prices and the extension of their near-term debt maturities at a reasonable cost.

Remain selective due to expensive valuations

Balancing the risk-reward in bond selection has turned arduous due to expensive valuations. We avoid single A or longer-duration bonds due to their tight valuations and sensitivity to rising rates. Within the Chinese property sector, we prefer BBB issues and larger-scale BB developers with good access to capital and liquidity. We also like select non-rated bonds, select corporate perpetuals with a meaningful yield pickup over senior bullet bonds (i.e. those whose entire face value is paid on the maturity date), and select short-dated China industrial bonds.

Asia ex-Japan equities: Continued uptrend; look for laggards and election beneficiaries

Our key messages for the coming year: 1) earnings growth is likely to continue and multiples could re-rate moderately; 2) the cyclical component of tech may partly roll over, but the structural stories remain intact; 3) Indonesia and Thailand, among Southeast Asia's laggards, and the banking and consumer sectors may catch up; and, 4) the focus is on infrastructure and consumer stocks in countries about to visit the ballot box.

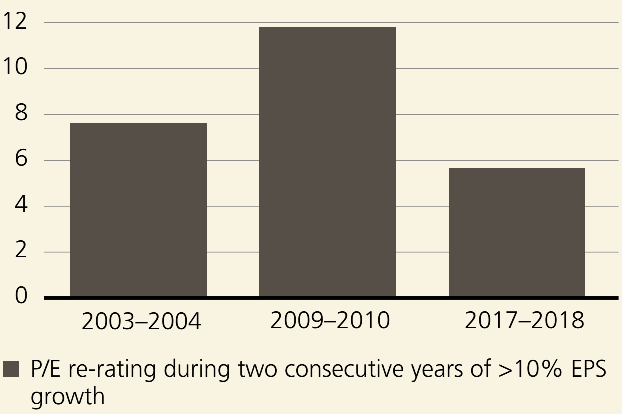
The case for AxJ's P/E multiple expansion
Contrary to general perception, the price-to-earnings (P/E) ratio of Asia ex-Japan (AxJ) expanded by less than 5% in 2017 thanks to earnings growth and currency tailwinds. Earnings will remain a key driver in the coming year, in our view; we expect them to rise by 11%. Only twice in the past 15 years have earnings grown by a double-digit rate for two straight years (2003–04 and 2009–10) on the strength of a broader economic recovery. Investors rewarded the markets well, driving P/E multiples up by an average 8% both years (see Figure 4.12). We anticipate AxJ markets re-rating moderately in 2018 as the region's sustainable innovation-driven growth becomes more apparent. The region now trades on a forward P/E of about 13.2x, slightly above the 15-year average of 12.5x.

Broadening growth
Asia's performance in 2017 was concentrated. The top 15 stocks accounted for over half of it. The good news is that growth will likely broaden, with markets like North Asia and Southeast Asia plus India converging, just as the returns between cyclical and defensive sectors likely will, we believe. The coming year should be the first in almost a decade in which every sector will post earnings growth, so the gap should narrow. We see a broad-based

Figure 4.12

Upside from higher valuations has been limited so far, scope for more

In %



Source: Bloomberg, UBS, as of 6 November 2017

earnings recovery supporting the region's valuations and producing 13–14% returns.

What to do with concentrated performers

With earnings growth broadening, we expect markets to start paying attention to laggards. Any rotation should happen gradually, however, as 2017's best performers – North Asia and the IT sector – should continue to fare well, in our view. We do see select opportunities in Southeast Asia (Indonesia, Thailand) and in the financial and consumer sectors. While most of the structural trends in technology are intact, the sector benefited from cyclical tailwinds like memory pricing and margin recovery that may fade in 2018. So we expect the cyclical part of technology like hardware or semiconductors to partly roll over, while structural stories like the Internet should continue to fare well.

Pre-elections – how investors can benefit from sweeteners

Malaysia's general election will likely occur after the populist measures of the 2018 budget take effect and before Ramadan begins, so sometime between March and mid-May. Thailand should hold its election in November, although who will run is still not known. Malaysia will focus on approving, and Thailand on executing, infrastructure projects, throwing infrastructure and property names into focus. Indonesian and Indian elections will follow in spring 2019, but their governments will probably seek to warm up voters before then.

In Indonesia, public investment has increased to such an extent that it is no longer likely to boost growth. We expect incremental growth to come from consumer-related government spending, including the stable pricing of

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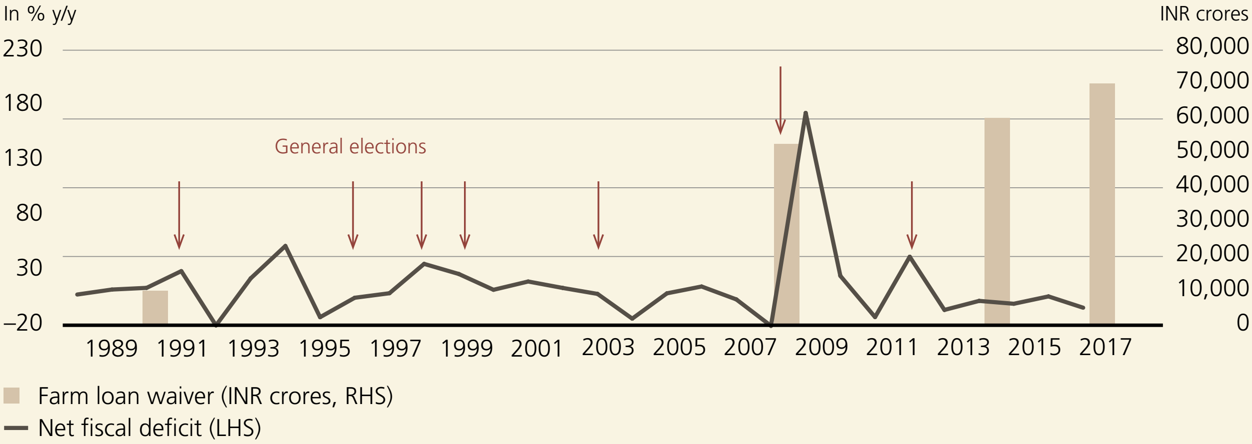
power and fuel. Some 10 million households will benefit from social assistance such as healthcare, education, social protection funds, and cash handouts, up from the previous six million. We favor stocks catering to low-end consumption. India has become a touch more populist, offering costly farm loan waivers in several states and delivering hikes in minimum support prices for agricultural produce that are decoupled from inflation (see Figure 4.13). Rural consumption and infrastructure names that benefit from construction, cement, and paint demand via the housing-for-all program look appealing.

All these countries' deficits are historically low, so they have scope to spend, which could lead to an uplift that should boost firms' earnings.

Figure 4.13

Loan forgiveness for farmers, the new pre-election normal



Source: Bloomberg, UBS estimates, as of 6 November 2017

Japan equities: A fourth arrow is needed

We remain neutral on Japan in our global tactical asset allocation. We like companies that benefit from the structural tightening of the labor market, rising price pressures, and global innovation trends.

Abe's landslide victory shifts focus from economy

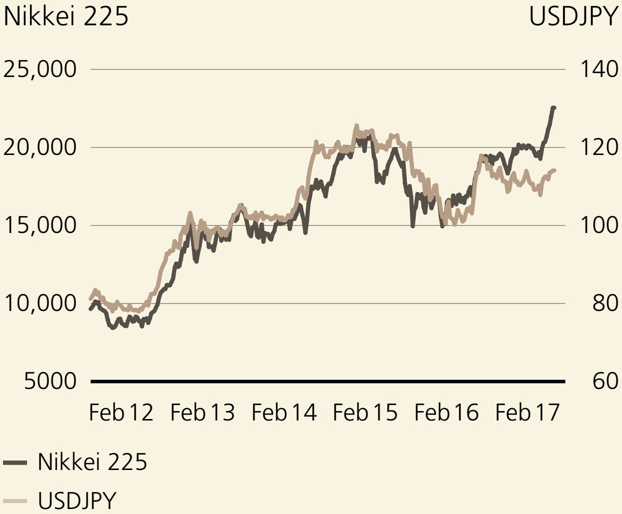
Prime Minister Shinzo Abe's landslide victory in the Lower House election in October has pushed Japan's Nikkei Index to a post-1991 high. Investors have equated the result with a continuation of Abenomics and the likely reappointment of Bank of Japan (BoJ) Governor Haruhiko Kuroda. While Abe's victory preserves the status quo, a continuation of past policies will not be enough to sustain the current rally, in our view. We think Abenomics, in its current form, can do little to further lift growth or productivity. Also, Abe will likely shift his focus from economic reform to constitutional change – i.e. the re-classification of Japan's self-defense stance (Article 9). Meanwhile, we think the value-added tax (VAT) hike will be implemented as scheduled in October 2019.

BoJ likely to raise yield target

Monetary policy will be a key driver of Japan's financial markets in the year ahead. We expect the BoJ to reduce purchases of government bonds (JGBs) to around JPY 50trn a year from JPY 80trn. With inflation and US interest rates set to rise, the BoJ is likely to raise the JGB 10-year yield target from around zero to 0.2% sometime in 2018. Though we anticipate the actual 10-year rate climbing to

Figure 4.14

Nikkei 225 correlation to USDJPY has weakened



Source: Bloomberg, UBS, as of 8 November 2017

0.2%, a stable rate gap between the US and Japan should continue to support USDJPY (our forecast is 115 over 3–12 months).

Investors' expectations too high

The post-election equity market is now vulnerable to profit taking, we believe. Consensus FY18 expectations look inflated for three reasons: First, as mentioned earlier, Abe's administration is likely to prioritize constitutional amendments over enhancing Abenomics, whose three arrows – fiscal stimulus, quantitative easing, and economic reforms – appear to be losing their effectiveness. Unless Abe launches a fourth arrow – such as incentives for Japanese companies to boost capital expenditures, R&D, and/or wages – investors are likely to be disappointed, in our view.

Second, Japanese corporate earnings should decline as one-time positive factors fade in the coming quarters. We believe investors ignored periods of USDJPY strength in their earnings expectations for 2017 despite the historical connection between the two (see Figure 4.14). Although Japanese companies' earnings power, particularly at the operating profit level, has strengthened considerably in recent years, net profit growth trends appear less compelling. While operating profit growth should continue at a steady pace, net profit probably won't follow suit (see Figure 4.15).

Third, we are concerned about Japanese equities' performance imbalance. Higher price/book value (P/BV) stocks outperformed low P/BV stocks in 2014 and 2015. This discrepancy was also observed in 2016 but came about more because of low P/B ratio stocks' underperformance. The outperformance of high P/BV stocks in 2017 looks excessive, however, as their return on equity (ROE) increased only moderately.

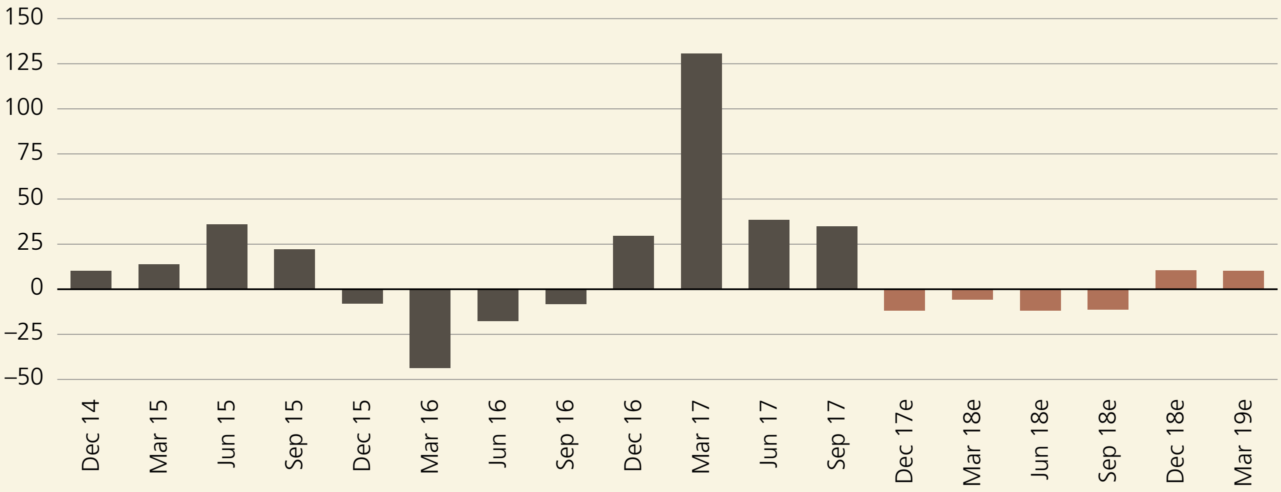
Overall, we think net profit will grow by 12% in FY17 and then contract by 2% in FY18. One main risk to our view is a weaker-than-expected JPY – every 1% rise in USDJPY from our target level of 115 would add 0.4–0.5 ppt to net profit growth.

Our sector picks are innovation and banks
We remain neutral on Japanese equities in our global tactical asset allocation, but see opportunities within the asset class. One key theme is stocks that benefit from the tighter labor market and government-driven work-life balance initiatives. These structural trends will increase capital expenditure on automation, in our view. We also like robot/automation companies and Internet-based service companies, Japanese banks for their attractive dividend yield (3%) and P/BV ratio (0.6x), and some electric automobile companies amid the electrical vehicle wave.

Figure 4.15

Japanese companies' net profit growth

In % y/y



Source: Bloomberg, UBS, as of 8 November 2017

Currencies: Moderate appreciation in 2018

We expect Asia ex-Japan (AxJ) currencies to appreciate by an average of 3% relative to the USD in 2018, and we forecast USDCNY at 6.5 in 12 months.

Favorable macroeconomic backdrop
Thanks to a likely benign macroeconomic backdrop in 2018, we expect AxJ currencies to appreciate by an average of 3% against the USD. Compared to the 4.4% rise versus the USD in the first 10 months of 2017, the performance of AxJ currencies should moderate for several reasons.

First, the 2017 appreciation of AxJ currencies should be seen in the context of 2016, when they plummeted against the USD late in the year in the wake of the US presidential election. In reality, the year-on-year performance of AxJ currencies was more muted: over a 12-month period through October 2017, they appreciated by around 1% on average versus the greenback.

Second, we do not expect faster growth in Asia. On an aggregate level, AxJ GDP should expand at 6.1%, about the same pace as in 2017. But on an individual country level, the growth of six out of 10 countries will probably level off after a strong pickup in 2017. As it does so, strong upward pressure on local currencies looks unlikely (see Figure 4.16).

Third, inflation in Asia is likely to pick up, but at a moderate pace that warrants only cautious tightening by local central banks. Histori-

Tokyo, Japan. iStock

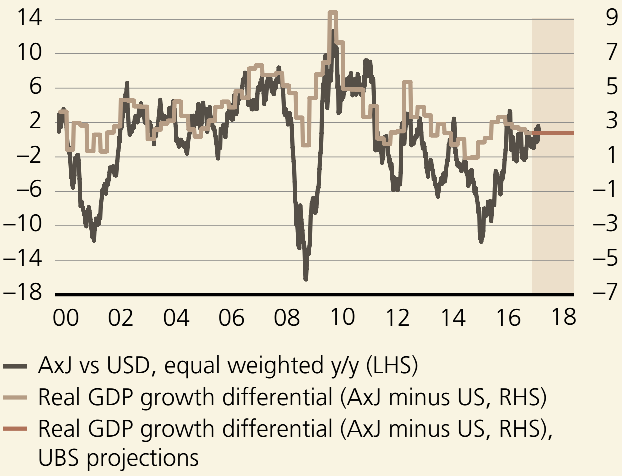
cally, periods of appreciating AxJ currencies have corresponded with soaring inflation, as occurred between late 2005 and early 2008, when Asia's average inflation rate more than doubled, from about 3% to nearly 8%. Above-target inflation motivates Asian central banks to tighten monetary conditions by hiking policy rates and/or allowing stronger currencies to keep prices under control. We project inflation to climb moderately to about 2.7% in 2018 (from 2.1% in 2017), but to remain below target in most countries (see Figure 4.17). As such, we think regional central banks would be circumspect about policy tightening as well as currency strength.

Last, we expect less-pronounced EUR appreciation in the coming year than in 2017, considering that EURUSD is much less undervalued today. Shifts in EURUSD tend to influence AxJ currencies, particularly the SGD and the CNY, since the central banks in charge of these currencies manage them based on a trade-weighted approach.

Figure 4.16

Growth outlook suggests moderate AxJ appreciation in 2018

In %, shaded area indicates year 2018

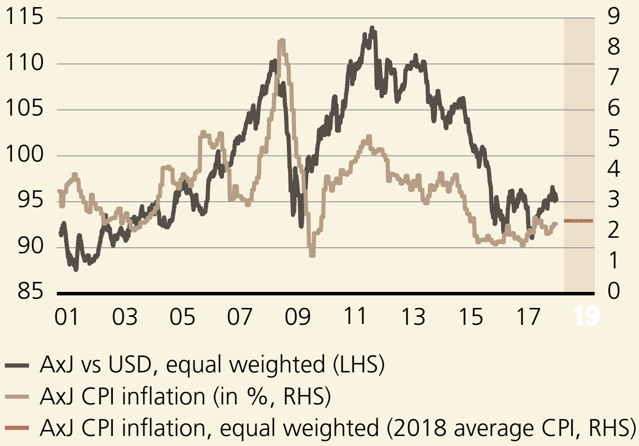


Source: Bloomberg, UBS, as of 31 October 2017

Figure 4.17

Subdued inflation outlook in 2018 will constrain Asian policymakers' appetite for stronger currencies

Shaded area indicates year 2018



Source: Bloomberg, UBS, as of 31 October 2017

Performance likely to vary from currency to currency

Against a backdrop of continued global growth, higher US interest rates, and broad USD weakness, we see three different currency profiles. We expect the most upside for the currencies of countries with strong current account surpluses and the potential for tighter monetary policies (e.g. KRW, TWD, THB, SGD, and MYR), which should appreciate by around 3–5% versus the USD, in our view.

The currencies of countries with widening current account deficits (e.g. IDR, INR, and PHP) will find it more challenging to attract capital inflows on the back of rising US rates, but they should remain fairly stable amid a weak USD environment. The CNY will continue to be tightly managed: we see it rising modestly against a broadly weaker USD, but it should still depreciate in trade-weighted terms because of slower Chinese economic growth.

Relative-value trades in Asia

Within the region, we favor being long INR versus short IDR. Broad USD weakness should benefit the INR more than the IDR, considering Bank Indonesia's desire to accumulate foreign exchange reserves. Also, the IDR is more vulnerable to rising US rates, thanks to the high foreign ownership of local government bonds. We prefer being long MYR versus short PHP in view of the currency-stabilizing measures taken by the Malaysian central bank, and a further deterioration in the Philippines' current account deficit. We also advise being long KRW versus short TWD, given stronger growth and inflation dynamics in Korea relative to Taiwan.

Economic and political calendar

What APAC investors should watch out for in 2018

Country	Event	Date	Why is it important?
Japan	Details of ordinary budget and tax reform for FY2018, Details of the supplementary budget in FY2017	Dec 17	The focus should be on the details of corporate tax reforms and the size of the supplementary budget.
Japan	Government to release new target on fiscal consolidation	Jan 18	PM Abe has already delayed the target for the primary balance to achieve a surplus to 2020. But a new target is likely to be released in the government's mid- to long-term economic and fiscal projection at the end of January 2018.
China	National People's Congress (NPC) & Chinese People's-Political Consultative Conference (CPPCC)	Mar 18	The annual NPC meeting includes reviewing and approving the annual work report, setting growth targets and agreeing to a budget plan. Government positions and titles will also be announced. The CPPCC will cover important political, economic and social issues.
Japan	Change of BoJ's vice governors (candidates to be released by the year-end at the earliest)	Apr 18	The market has already priced in the continuity of current governor Kuroda. So a change in governor could impact Japan's market.
Singapore	MAS monetary policy meeting	Apr, Oct 18	MAS kept all the policy parameters unchanged in its October MPS; however, it dropped the commitment to keep SGD NEER on a zero slope for an "extended period." We do not see concerns (such as uneven growth recovery and lack of wage inflation pressures) going away anytime soon. Our base case is a flat slope for 2018.
Indonesia	17 regional elections, e.g. Central, East and West Java	Jun 18	Could add up to 0.1% additional GDP due to election-related spending.
China	Sino-US Comprehensive Economic Dialogue	Jul 18	This high-level bilateral economic forum was established by President Xi and President Trump in April 2017 to enable both countries to address and resolve a comprehensive set of economic issues.
Malaysia	14th Malaysian general election	By 24 Aug 18	Our base case is a UMNO win. The opposition is now more split than before, making it essentially a three-way competition. No major impact expected, economic programs not too dissimilar and pro-growth. However, some infrastructure projects may be scrutinized more by opposition.
Japan	Ruling party LDP's representative election	Sep 18	If PM Abe's approval rating sinks even lower, he might not survive this election. In such a case, Kishida would be the next PM and the market would likely react negatively to the end of Abenomics.
China	3rd Plenary Session of 19th Central Committee	Oct/ Nov 18	The meeting is held by the newly elected central committee every five years to discuss and make decisions on deeper and more comprehensive reforms.
Thailand	General election	Nov 18	Elections were delayed several times; the current plan is November 2018 (exact date to be set in June). The PM candidates have to be vetted eventually by the lower and upper house. The latter (senate) is appointed by the military. The army-led government focuses on execution of infra. projects, and it should retain some influence after the election.
China	Central Economic Work Conference	Nov/ Dec 18	The meeting is held annually to review progress in the past year and to address key policy tasks for the coming year.
Taiwan	Municipal elections	Dec 18	Mid-term elections for the Tsai administration should have a minimal impact on markets. Support ratings for Tsai's party have fallen this year, and her approval remains well below the May 2016 post-election high. But voters are undecided on party identification.
India	Eight state elections in India throughout the year	2018	Key to watch will be if populist measures such as farm loan waivers become more common. If yes and on a larger scale, it might be taken negatively by markets on inflation and bank NPL fears (moral hazard rather than actual NPLs since the states are reimbursing the banks).

Source: UBS, as of November 2017

Strategy and forecast overview

UBS APAC economic forecasts

% change y/y

	GDP				CPI			
	2015	2016	2017E	2018E	2015	2016	2017E	2018E
Australia	2.4	2.5	2.3	2.7	1.5	1.3	1.9	2.0
New Zealand	2.5	3.0	2.5	2.7	0.3	0.6	1.9	2.2
China	6.9	6.7	6.8	6.4	1.4	2.0	1.5	2.2
Indonesia	4.9	5.0	5.1	5.4	6.4	3.5	3.8	3.5
Malaysia	5.0	4.2	6.0	5.5	2.1	2.1	3.9	2.4
Philippines	6.1	6.9	6.7	6.8	1.4	1.8	3.0	3.8
Thailand	2.9	3.2	4.0	3.7	-0.9	0.2	0.7	1.3
South Korea	2.8	2.8	3.0	3.0	0.7	1.0	2.0	2.2
Taiwan	0.7	1.5	2.4	2.3	-0.3	1.4	0.6	1.0
India	8.0	7.1	6.6	7.4	4.9	4.5	3.4	4.0
Singapore	1.9	2.0	3.3	2.8	-0.5	-0.5	0.5	0.9
Hong Kong	2.4	2.0	3.7	3.5	3.0	2.4	1.8	3.4
Japan	1.1	1.0	1.8	1.8	0.8	-0.1	0.5	1.3
Asia ex-Japan	**6.3**	**6.1**	**6.2**	**6.1**	**2.4**	**2.5**	**2.1**	**2.7**
APAC	**5.6**	**5.4**	**5.6**	**5.6**	**2.2**	**2.2**	**2.0**	**2.5**

Source: UBS, as of 27 November 2017

Forecasts for APAC currencies versus the USD

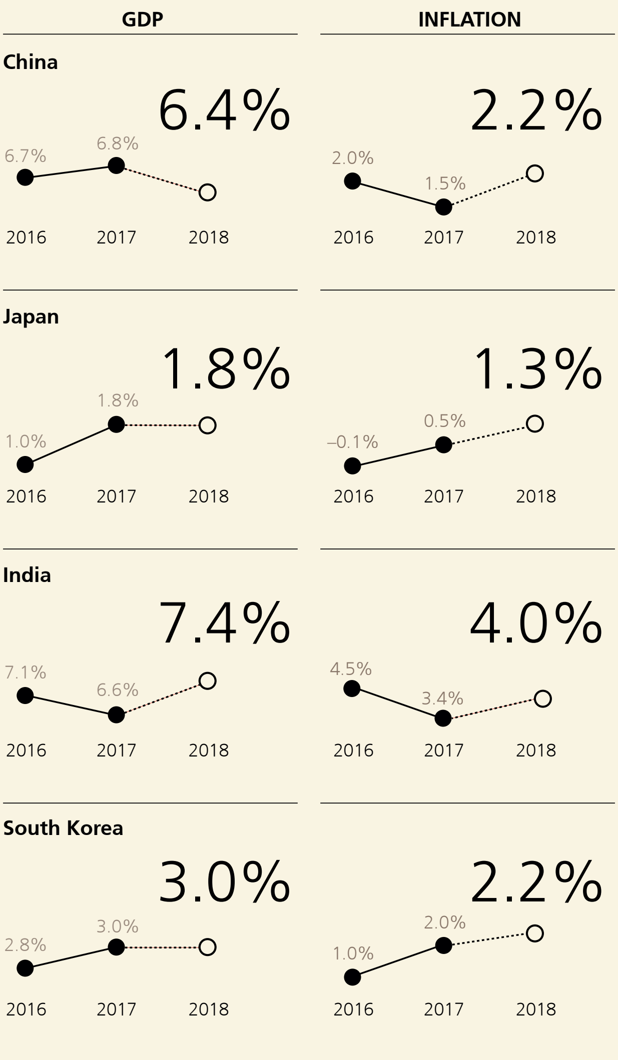
APAC currencies should appreciate moderately in 2018

	15-Nov-17	3M	6M	12M
USDCNY	6.63	6.60	6.55	6.50
USDHKD	7.81	7.80	7.80	7.80
USDINR	65.3	64.0	64.0	64.0
USDIDR	13,532	13,500	13,500	13,500
USDKRW	1,110	1,100	1,080	1,060
USDMYR	4.18	4.10	4.10	4.00
USDPHP	51.0	51.0	51.0	50.5
USDSGD	1.36	1.36	1.34	1.32
USDTHB	33.0	32.8	32.5	31.8
USDTWD	30.1	29.8	29.4	29.0
AUDUSD	0.76	0.76	0.79	0.79
NZDUSD	0.69	0.67	0.71	0.71
USDJPY	113	115	115	115

Source: Bloomberg, UBS, as of 15 November 2017

Economic forecast Asia

Robust growth continues



Source: UBS, as of 27 November 2017

Equities

Entering 2018

- **Overweight global equities:** We overweight global equities as we enter the new year. Vigorous global economic expansion should drive earnings growth of 8–12%, and we expect central banks to tighten monetary policy only gradually.

- **Prefer Eurozone stocks:** Regionally, we favor Eurozone stocks, which we overweight relative to UK equities. Leading Eurozone economic indicators are at multiyear highs, and the region's companies are highly geared to an improving global economic cycle.

- **Smart beta and technology in focus:** Two of our preferred themes are US smart beta and transformational technologies.

For the long term

Although stocks can be vulnerable to short-term surprises in economic growth, monetary policy, and geopolitics, equities have proven the most effective way to increase wealth over the long term, with US equities delivering 9.6% annualized returns over the past 90 years. Returns are likely to be lower than they have been in recent years (c. 6–8%), but still superior to other asset classes.

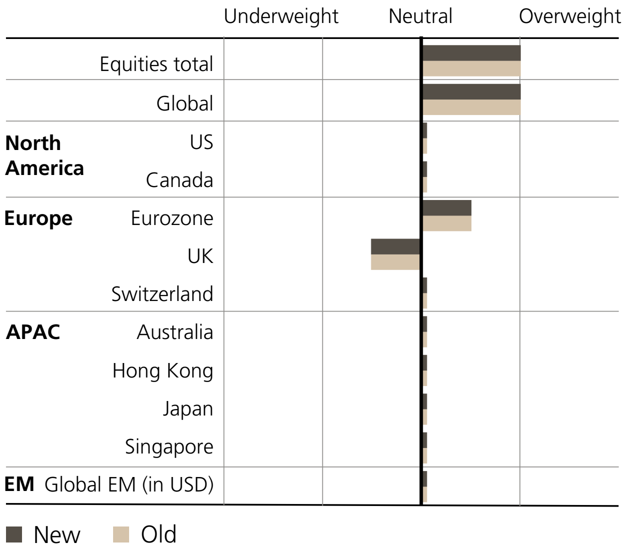
Themes for 2018

- **US smart beta:** Diversified exposure to "smart beta" factors such as momentum, quality, small capitalization, risk-weighted, value, and yield can deliver long-term investment outperformance. An equally weighted portfolio of these six factors has, in the US, outperformed MSCI USA by 2.1% a year, back-tested to 2001.

- **Transformational technologies:** Companies playing a key role in technological disruption can outperform the wider market, in our view. We favor US technology, a currently preferred sector, as well as making longer-term investments in automation and robotics, digital data, and smart mobility.

TAA positioning chart

Preferences (six months)



Preference in hedged terms (excl. currency movements)
Source: UBS as of 16 November 2017

Bonds

Entering 2018

– **Modestly higher bond yields:** We foresee a moderate increase in short and medium-term bond yields as monetary policy tightens. Longer-term yields are closer to fair value.

– **Limited value in high yield credit:** Low spreads limit US high yield upside, and we underweight euro high yield, where yields are at an all-time low of just 3.0%.

– **We see good value in selected emerging markets:** Valuations compare favorably to other regions and should be underpinned by accelerating economic growth.

For the long term

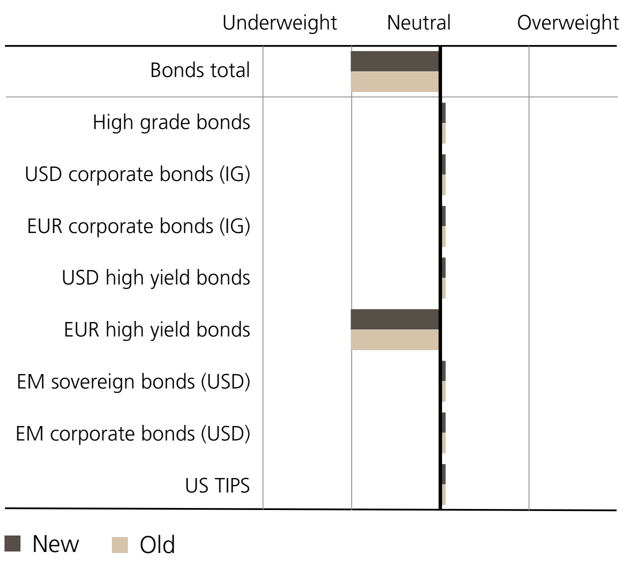
Long-term returns are unlikely to match historical norms due to today's extremely low yields. But muted long-term economic growth, aging populations, and regulatory pressures should provide structural support. We anticipate returns of 0–5% (depending on currency and credit risk) over the long run and believe fixed income should remain an integral part of well-diversified portfolios.

Themes for 2018

– **Select EM credits:** The global environment should still support the emerging market (EM) business and credit cycle, and we see pockets of opportunity within EM credit. An actively managed portfolio of EM sovereign and corporate bonds could yield returns of around 5% in the next 12 months, in our view. In fixed income portfolios we overweight EM credit versus euro high yield.

TAA positioning chart

Preferences (six months) and duration overlay



Source: UBS as of 16 November 2017

Alternatives

Entering 2018

- **Low correlation should enable alpha generation:** Correlations between stocks on the S&P 500 are at a decade-long low, and we believe the end of easy money is likely to keep them there. Low intra-stock correlations have historically spurred alpha generation.

- **Valuation dispersion creates mean-reversion opportunities:** Although the dispersion between stocks is still low, high valuation dispersion means that it could rise if markets begin to focus on relative valuations.

- **Well-positioned for tighter policy:** Hedge funds have historically outperformed other asset classes during periods of tighter monetary policy.

For the long term

We believe most investors should allocate between 14% and 18% of their portfolio assets to hedge funds. Investors with a higher illiquidity tolerance could allocate up to 40% to non-traditional markets as a whole. Adding hedge funds can both improve the returns and lessen the volatility of an equity-bond-only portfolio. We also expect private markets to earn superior returns to public markets over the long term due to illiquidity premia. Diversification across managers and styles is key to stabilizing returns and reducing single-manager risk.

Highest conviction

We continue to recommend strategies that follow differentiated investment approach with low directionality and that seek to generate returns uncorrelated to those of traditional markets. Meanwhile we also see value in selected equity event driven strategies.

Currencies

Entering 2018

- **High-beta currencies to outperform safe havens:** The positive global growth environment should generally favor "risk-on" currencies (e.g. the SEK, EUR, and EM) over the "safe havens" (the CHF, JPY, USD).

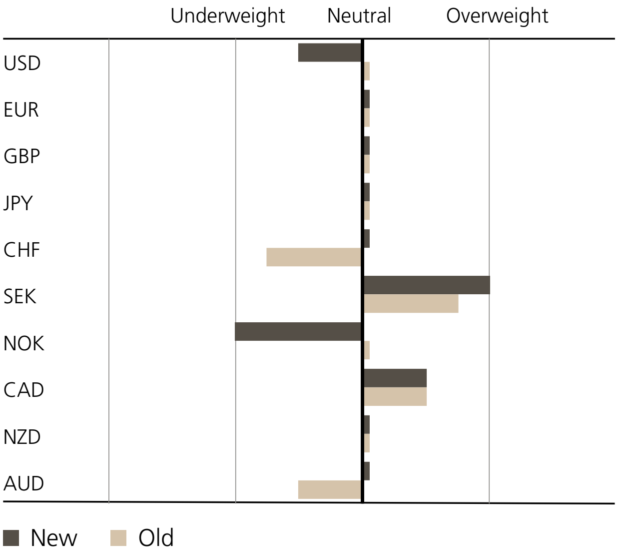
- **Volatility likely to rise:** Uncertainty over the pace and sequencing of central bank moves toward tighter monetary policy will likely result in higher currency volatility, increasing the importance of hedging.

For the long term

While investors can benefit from foreign exchange movements in the short term, i.e. three to six months, we find that within the G10 universe the return of carry trades does not compensate them for currency risk. Currency exposure also fails to reward equity or bond investors with additional returns over the long run. As such, we generally advise investors to use hedges to ensure the currencies of their assets match those of their liabilities and regular outgoings.

TAA positioning chart

Preferences (six months)



Source: UBS as of 16 November 2017

Highest convictions

In our tactical asset allocation, we hold two currency positions as we enter the new year:

– **Overweight SEK versus NOK:** The Swedish krona is our top pick over the next 12 months. Sweden's vigorous economic growth and rising inflation should lead to rate hikes that support the SEK. Meanwhile, we believe Norway's weak housing market and falling inflation mean rates there will remain on hold, and negatively affect the NOK.

– **Overweight CAD versus USD:** We are positive on the Canadian dollar. We see the Bank of Canada at least matching the US Federal Reserve's pace of rate hikes, given Canada's robust growth and rising wages. Current real swap spreads indicate that the CAD should trade stronger, and we also consider it undervalued relative to the US dollar on purchasing power parity.

Currency-by-currency views

– **US dollar:** We foresee the greenback trading moderately weaker next year. Tax reforms provide some near-term potential support, but longer term the twin US current account and fiscal deficits are likely to hurt the currency.

– **Euro:** Solid Eurozone growth, rising trust in the European Central Bank's ability to manage political risks, a high and rising current account surplus, and only moderate US rate hikes should underpin the euro through the coming year and beyond.

– **Swiss franc:** We expect the franc to weaken moderately against the euro, as stronger global growth reduces the demand for the safe-haven currency.

– **British pound:** The pound will remain flat against the dollar, in our view, while weakening against the euro. The recent UK interest rate hike should bolster sterling in the near term, but a sputtering economy and Brexit uncertainty are longer-term drags.

– **Japanese yen:** The Bank of Japan could end the coming year as the only central bank still engaged in quantitative easing, which suggests a weaker yen. The extent of yen downside will depend on the pace of US rate hikes.

Commodities

Entering 2018

- **A good start:** Vigorous global economic activity across all regions should buoy commodity demand and prices in the first half of the year. Demand growth for oil is above trend, and reduced industrial metals output in China should underpin prices.

- **A weaker finish:** We expect first-half gains to evaporate by year-end. Greater demand for oil is likely to be more than offset by increased output in the Americas and from OPEC in the second half.

For the long term

We do not hold an allocation to commodities in our strategic asset allocation since diversified commodity indexes have failed to sufficiently compensate investors for their volatility over the long run.

Highest conviction

Firm demand growth and ongoing supply challenges should support higher copper and aluminum prices in 2018. Aluminum production closures in China have the potential to tighten the market particularly firmly. Meanwhile, gold and silver prices should be supported by a weaker USD and renewed inflation pressure. Negative real rates in the US favor higher precious metal prices.

Commodity-by-commodity

- **Oil:** We expect oil prices to peak early in the year. While demand growth remains above trend, it will be more than offset by increased output in the Americas and from OPEC in the second half of the year. We forecast Brent at USD 57/bbl in 12 months.

- **Industrial metals:** Reduced output in China and greater industrial demand should lift industrial metal prices. Since supply curbs affect some metals more than others, outcomes will vary.

- **Gold:** Monetary tightening and global growth will challenge gold prices. But geopolitical uncertainty, higher inflation, and a weaker dollar should underpin demand, particularly in 2H18. We forecast the gold price at USD 1,325/oz. in 12 months.

- **Agriculture:** We believe agriculture prices are bottoming out. Inventory-to-consumption ratios have peaked, in our estimate, and we think weather risks have risen alongside the increased likelihood of a La Niña event.

Economic forecasts

	GDP growth (%)				Inflation (%)			
	2016	2017E	2018E	2019E	2016	2017E	2018E	2019E
Americas								
US	1.5	2.2	2.2	2.3	2.1	1.9	2.0	2.3
Brazil	–3.6	0.5	3.1	2.7	6.3	3.1	3.7	4.2
Canada	1.5	3.6	2.5	2.3	1.5	1.3	2.1	2.2
Europe								
Eurozone	1.8	2.3	1.9	1.7	1.1	1.1	1.6	1.6
– Germany	1.9	2.2	1.9	1.6	1.7	1.1	2.0	1.7
– France	1.1	1.8	1.8	1.6	0.8	1.0	1.6	1.5
– Italy	1.1	1.5	1.3	1.0	0.5	0.8	1.4	1.2
– Spain	3.3	3.1	2.3	1.9	1.4	0.9	1.4	1.5
UK	1.8	1.5	1.1	1.1	1.2	3.0	2.5	2.1
Russia	–0.2	1.9	1.7	1.8	5.4	3.0	4.2	4.0
Switzerland	1.4	0.8	1.8	1.8	–0.4	0.5	0.6	0.9
Asia								
China	6.7	6.8	6.4	6.3	2.1	1.5	2.2	1.9
Japan	1.0	1.8	1.8	1.1	0.1	0.8	1.5	3.4
India	7.1	6.6	7.4	7.7	3.6	4.4	4.0	4.2
South Korea	2.8	3.0	3.0	3.0	1.3	2.0	2.1	2.8
Advanced economies	1.6	2.2	2.1	2.0	1.4	1.5	1.9	2.2
Emerging markets	4.4	5.1	5.2	5.3	3.9	3.3	3.4	3.2
World	3.1	3.8	3.8	3.8	2.8	2.5	2.7	2.8

Source: UBS, as of 20 November 2017

Rates and bonds

	Base rates			10-year yields (%)		
	Current	End-2017	End-2018	Spot	6m	12m
USD	1.00–1.25	1.25–1.50	1.75–2.00	2.36	2.50	2.50
EUR	–0.40	–0.40	–0.40	0.36	0.60	0.70
CHF	–0.75	–0.75	–0.50	–0.16	0.00	0.10
GBP	0.50	0.50	0.50	1.29	1.50	1.70
JPY	–0.05	–0.05	–0.05	0.03	0.15	0.20

Source: UBS, as of 20 November 2017

Commodities

	Spot	6 month	12 month
Brent crude oil (USD/bbl)	62.0	57.0	57.0
WTI crude oil (USD/bbl)	56.2	53.0	53.0
Gold (USD/oz)	1,288	1,250	1,325
Silver (USD/oz)	17.0	17.5	18.5
Copper (USD/mt)	6,777	7,100	7,100

Source: UBS, as of 20 November 2017

Currencies

Developed market

	Spot	6 month	12 month	PPP
EURUSD	1.18	1.22	1.25	1.26
USDJPY	112	115	115	76
GBPUSD	1.32	1.36	1.36	1.59
USDCHF	0.99	0.97	0.95	0.96
EURCHF	1.17	1.18	1.19	1.21
EURGBP	0.89	0.90	0.92	0.80
AUDUSD	0.76	0.79	0.79	0.70
USDCAD	1.28	1.20	1.20	1.19
EURSEK	9.97	9.20	9.20	9.06
EURNOK	9.75	9.60	9.80	9.95

Source: UBS, as of 20 November 2017

Emerging market

	Spot	6 month	12 month
USDCNY	6.64	6.55	6.50
USDIDR	13,529	13,500	13,500
USDINR	65.00	64.00	64.00
USDKRW	1,100	1,080	1,060
USDRUB	59.40	58.00	55.00
USDTRY	3.90	3.60	3.80
USDBRL	3.26	3.00	2.90
USDMXN	19.00	18.50	19.00

Source: UBS, as of 20 November 2017

Key events

2017

Nov
- November 30, OPEC meeting

Dec
- December 8, US debt ceiling
- December 13, FOMC meeting
- December 14, ECB meeting
- Dec. 14, US Congress' deadline for Iran's Nuclear Deal

2018

Jan
- Jan. 23–26, 48th World Economic Forum Annual Meeting
- January 23, BoJ meeting
- January 25, ECB meeting
- January 31, FOMC meeting

Feb
- February 8, BoE meeting

Mar
- March 8, ECB meeting
- March 9, BoJ meeting
- March 13–15, World Economic Forum on Latin America
- March 21, FOMC meeting
- March 22, BoE meeting
- Late March, Italian general election

Apr
- April 26, ECB meeting
- April 27, BoJ meeting

May
- May 2, FOMC meeting
- May 10, BoE meeting

Jul
- July 1, Mexican general election

Sept
- September 13, ECB meeting (currently expected to end QE)

Oct
- October, Deadline to agree Brexit negotiations

Nov
- November 6, US mid-term elections

Dec

Risk categories
- Central bank policy
- Chinese credit crunch
- Emerging Markets politics
- European politics
- Geopolitics
- Rising protectionism
- Trumponomics
- United States politics

Ongoing monitoring

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

Chinese credit crunch
- PMIs and industrial production
- Fixed asset and intrastructure investments
- FX reserves

European politics
- Brexit negotiations
- Catalonian independence
- Italian general election
- EU refugee crisis

Geopolitics
- US-China relations (e.g. One China policy, South China Sea)
- Geopolitics – other than US-China relations (e.g. Middle East)
- Cyber attacks
- Sanctions (e.g. Russia, Iran)

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

Trumponomics
- Trump policy with respect to:
  1) Tax reform
  2) Regulatory relief
  3) Fiscal spending
  4) Global engagement

Year Ahead 2018 – UBS House View
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Contact
ubs-cio-wm@ubs.com
ubs.com/cio

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