Deal or no deal?
The market gains on hopes for a US-China trade deal are founded on positive signs, but may quickly evaporate if President Trump decides to impose scheduled tariffs.

Policy easing
Monetary policy has become looser in 3Q and real rates are low. Further easing is less certain, but the Federal Reserve appears to have no intention to go bubble hunting.

Little green shoots
Manufacturing weakness has yet to spill over into consumption. There are also signs of stabilization in manufacturing sentiment, which has been harder hit than output data.

Asset allocation
We close our underweight in international developed and EM equities, moving to a neutral stance on stocks overall. Within fixed income, we overweight TIPS and EM hard-currency bonds.

The winding road to Muscatine
The rise in stocks over the past month suggests that many investors would like to see Presidents Trump and Xi meet, in a freezing field near Muscatine, Iowa* posing for the world’s media with a giant USD 40bn check made out for tons of US soybeans.

We are skeptical about this particular image becoming a reality. Even the trade negotiators do not know at this point whether US President Donald Trump will go ahead with his 15 December tariff escalation, and trade advisor Peter Navarro has poured cold water on the current state of the talks. Yet, in the past month, there have been material signs that a deal is more likely.

Soybean field. Source: Getty images

* A young President Xi stayed in Muscatine in 1985 as part of a Chinese delegation.
First, China signaled it is willing to accept a partial rollback of tariffs as part of a deal. Second, both sides seem amenable to accepting compartmentalized agreements that make negotiating a deal less complex. Third, political pressure on President Trump to “declare victory” on trade is mounting ahead of next year’s elections, and was brought into sharp focus by recent Democratic gains in Kentucky, Virginia, and Mississippi. In our view, these factors make a complete breakdown in talks less likely and a “rollback” in tariffs possible, which makes the upside/downside risk around the tariffs more balanced than last month.

Meanwhile, fears of an inverted yield curve leading the world’s media to talk us all into recession have faded, as cuts in short-term US interest rates and tentative signs of stabilizing macroeconomic data have steepened the yield curve.

With earnings season largely complete, corporate profit growth expectations lowered, signs of a bottoming in economic indicators, and more balanced risks around trade negotiations, we have closed our underweight position in emerging market (EM) and international developed market equities, which could experience a sharp rally in the event of rollback.

Nonetheless, after what has been a great year for balanced portfolios, we still want to exercise some caution about positioning for further equity upside in the absence of more information on a US-China deal. So we have adopted a neutral stance on equities overall, while maintaining an overweight to EM US dollar-denominated (aka “hard currency”) bonds, which offer an attractive yield when compared to corporate bonds with similar credit risk.

Trade
There is a lot of rhetoric around the US-China trade conflict, and it can be hard to separate fact from fiction. Throughout this conflict, US officials in particular have been quick to talk optimistically about a trade settlement, only to have the president escalate tariffs. A G20 trade “truce” sent markets to a high in July only to have President Trump raise tariffs again a few weeks later. Why should we think a different outcome is possible this time?

First, we consider it significant that the Chinese Ministry of Commerce is now touting its willingness to agree to the US removing the additional tariffs it has imposed “in phases.” As recently as July, that same Ministry said: “If the two sides are to reach a deal, all imposed tariffs must be removed….China’s attitude on that is clear and consistent.” While the Trump administration has been disposed to going back and forth on trade, China has been more deliberate and steady in its messaging, so we see this move as potentially significant. President Trump himself tacitly implied that a phased approach is more workable: “China would like to get somewhat of a rollback, not a complete rollback because they know I won’t do it.”
Second, proposals on a Phase 1 agreement appear to include more tangible and limited deliverables than prior proposals that were sweeping in the breadth of issues to be included. President Trump appears to have backed away from a “grand deal or no deal” stance. An agreement would likely include purchases of agricultural goods by China and the rollback of Chinese tariffs on them. In exchange, the US may cancel the 5% tariff on USD 250bn of goods, which had been scheduled for October, and postpone the December tariff increase. Further opening of China’s financial services sector and some commitment around yuan stability might also form part of a deal. The thorniest issues such as technology transfer, Chinese competition policy and cyber intrusions, however, are unlikely to be included.

Third, this month’s elections in Kentucky, Virginia, and Mississippi produced Democratic gains. Political pressure ahead of the 2020 elections is rising, and a workable agreement would enable President Trump to “declare victory” ahead of the vote. Of course we need to acknowledge that geopolitical gains can swiftly evaporate. President Trump has made clear that he hasn’t “agreed to anything,” and the delay in a signing date (now reportedly scheduled for December), suggests that reaching an agreement is neither straightforward nor guaranteed. Failure to do so would likely result in implementation of the 15 December tariffs and a reversal of recent market gains.

The market gains on hopes for a US-China trade deal are founded on positive signs, but may quickly evaporate if President Trump decides to impose scheduled tariffs.

It has been speculated that President Trump, in the style of Wag the Dog (a film in which a spin doctor fabricates a news story to distract attention from a presidential scandal), could be looking to use an agreement with China to limit the attention paid to impeachment proceedings. It may seem that every headline on trade lessens the media focus on impeachment, and the Congressional inquiry may be hurting his election prospects. However, our analysis of the president’s own Twitter account suggests that, rather than bury impeachment talk, his strategy is to lean in to the impeachment debate as a partisan issue. In the seven weeks since the impeachment inquiry was announced, 169 of his tweets have included the word “impeachment,” compared with just 27 containing the word “China” – i.e. half the number of China tweets he made in the seven weeks before the inquiry was launched.
Outside of the negotiations with China, we also see the US–Europe picture improving as auto tariffs now look much less likely than before. As recently as the end of October, it looked probable that European auto and car part manufacturers would be hit with US tariffs by 14 November. Yet, US Commerce Secretary Wilbur Ross has now suggested that capital investments in the US by European, Japanese, and Korean automakers could prompt the Trump administration to back down, while European Commission President Jean Claude Juncker has said he is “fully informed” that tariffs will not be imposed.

For more on this, please see our latest Global risk radar: *US-China trade: Route to de-escalation.*

**Looser policy**

The Federal Reserve’s rate cut in October marked its third since July, and recent measures to resume purchases of bonds have alleviated funding pressures in the repo market. The European Central Bank (ECB) has also eased policy, cutting its deposit rate by 10bps in September and resuming quantitative easing this month.

The Fed’s three rate cuts have helped steepen the yield curve. In August it briefly inverted for the first time in a decade, prompting widespread talk about a looming recession. In our view, the yield curve is not the accurate predictor of recessions it is often held to be. But a return to a positively sloped yield curve has boosted the performance of the financial sector, helped calm fears about an end to the economic cycle, and reduced the risk of a self-fulfilling downturn in investor and business confidence.

The future for monetary policy is now less clear. The Fed has indicated that it would like to be “on hold” and we think the ECB will be less radical under new President Christine Lagarde as she tries to build a consensus among hawkish ECB policymakers. It should be noted that she may make more progress on the political integration front, and signals that Germany’s finance minister, Olaf Scholz, may consider Eurozone-wide bank deposit reinsurance are positive.

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**Figure 2**

**Real rates are low and the yield curve has steepened**

Fed funds rate minus core CPI, US 2-year/10-year yield spread

On the whole, however, already accommodative monetary support has increased since the summer. The real fed funds rate (fed funds minus core CPI) has fallen to −0.9%, compared with 0.2% at the July equity peak. European bank lending condi-
tions eased in 3Q, reversing a trend toward tighter standards since 4Q18. The equity risk premium is up to 5.8%, despite the more than 21% rally in global stocks this year.

Furthermore, the Fed is signaling that it may allow the economy to run hotter for longer. Fed Governor Lael Brainard recently said that the Fed might entertain “opportunistic reflation,” overlooking price increases perceived as temporary, while Vice Chair Richard Clarida has said “measures of inflation expectations reside at the low end of a range I consider consistent with price stability.” If last year’s Fed tightening came straight from the traditional playbook in a late-cycle economy, the Fed currently appears to have no intention to go bubble hunting.

**Tentative economic stabilization**

Economic data this year has been characterized by weakness in manufacturing offset by resilience in consumption. Despite concerns that the downturn in manufacturing might spill over into the rest of the economy, US jobs growth has remained strong, as evidenced by better-than-expected US nonfarm payroll numbers in October.

That said, the slowdown in manufacturing has been more pronounced in sentiment than hard output data. The gap between sentiment and output is now the widest it has been in seven years. Whether hard data weakens or sentiment strengthens to close the gap will hinge on the outcome of trade negotiations.

For now the hard data is slowing. In the US, 3Q GDP growth inch ed down to 1.9% from 2% in 2Q, its slowest pace since 2Q16, due to a further fall off in investment. Chinese growth similarly eased to 6% from 6.2%, while Eurozone GDP was unchanged, but still weak at 1.2% in 3Q.

There have been signs of stabilization in manufacturing sentiment. Since the July market peak sentiment has fallen: the US ISM manufacturing index slipped to 48.3 in October from 51.2 in July; the Eurozone manufacturing PMI dropped to 45.9 from 46.5 and, in China, to 49.3 from 49.7. But the manufacturing PMI for Germany rose from 41.7 in September to 42.1 in October, and the US manufacturing ISM climbed to 48.3 from 47.8. If trade tensions moderate, we would expect the nascent improvement in sentiment to continue and narrow the gap with the hard data.
With the 3Q reporting season nearly complete, consensus earnings per share growth expectations have moderated to more realistic levels. For the current year they are just 0.6% in the US and 0.2% in the Eurozone, down from July’s forecasts of 1.9% and 4%, respectively. Global earnings and EM earnings have also been downgraded by 3% and 5%, respectively, over the same period.

**Asset allocation**
We have long maintained that, despite weakening economic data, central bank support would prevent a recession. Yet, after strong equity market performance this year, a re-escalation of trade tensions in August, and slowing growth, we felt that the best way to take risk was to emphasize earning yield rather than counting on further equity appreciation.

Now, the weight of upside and downside risks is more balanced: 1) the US-China trade negotiations have made some progress; 2) central bank accommodation has increased; 3) corporate earnings expectations have fallen; and 4) there are tentative signs of economic stabilization. Despite higher prices and the downside risks in evidence, upside has also increased, in our view. We have closed our underweight position in to international developed and EM equities, and are now neutral to stocks overall.

This month we highlight three main investment ideas:

**We overweight US dollar-denominated emerging market sovereign bonds versus US government bonds.** Against a backdrop of easy monetary policy, low global yields, and sluggish global growth (but no recession), EM bonds offer an attractive yield pickup of more than 3% versus US Treasuries. We expect the growth differential between emerging and developed economies to widen significantly in the former’s favor from 2.6% this year to 3.5% next, which should support our position. The asset class also offers diversification benefits, which helps mitigate idiosyncratic risks. For example, the index weight of countries that have experienced social unrest in recent weeks (Chile, Bolivia, Peru, Ecuador, Lebanon, Egypt, Iraq) is just 12%.

**Figure 4**

**USD EM sovereign bonds offer attractive yield**

| J.P. Morgan EMBIG Diversified ex. Venezuela spread-to-worst |
|---|---|
| 200 | 250 | 300 | 350 | 400 | 450 |
| Spread EM sovereign (ex Venezuela) bonds (USD) | Median |

Source: Bloomberg, UBS, as of 12 November 2019
In our FX strategy, we overweight select high-yielding emerging market currencies (IDR, INR) versus a set of lower-yielding ones (AUD, TWD). The Indonesian rupiah and the Indian rupee boast a yield advantage of around 5%-5.5% and 4.5%-5% respectively versus the US dollar. With global economic growth sluggish, domestic demand oriented economies like Indonesia and India are more insulated from weakening external demand.

We overweight Treasury Inflation-Protected Securities (TIPS) to benefit from a potential rebound in growth and inflation. TIPS can outperform nominal Treasuries when inflation expectations rise, as we expect to happen gradually now that the Fed has pivoted to a more growth- and inflation-supportive stance.

For more information on our recent changes and positioning, please see the “Asset allocation implementation” section, and our “Detailed Asset Allocation tables” companion report.

Mark Haefele
Chief Investment Officer
Global Wealth Management

UBS Investor Forum Insights

In this month’s Investor Forum, participants discussed the changing dynamics of trade negotiations, the state of the economic cycle, and the prospects for monetary and fiscal stimulus.

• All participants agree that trade tensions are unlikely to be resolved in the foreseeable future, but that the removal of trade discussions from the headlines could be sufficient for the market to move higher.

• Many participants agreed that we are now at the late-cycle stage of the economic expansion and many expect another rate cut from the Fed early next year.

• Participants were also focusing on the impact of long-term underlying trends and the shift toward incorporating environmental, social, and governance factors in investing. They stressed the importance for investors to understand which sectors/countries/companies will be the beneficiaries from those trends and which will be the losers, and adjust their portfolios accordingly.
Asset allocation implementation

The UBS House View is our current assessment of the global economy and financial markets, with corresponding investment recommendations. The asset allocation implementation of this view can vary across model portfolios, depending on their objectives.

Our Tactical Asset Allocation (TAA) recommendations

Overweights
- China and Brazil equities (all-equity portfolio)
- Treasury Inflation-Protected Securities (TIPS)
- Emerging market (EM) USD-denominated sovereign bonds
- Senior loans (yield-focused portfolio)

Underweights
- US government bonds
- Preferreds (yield-focused portfolio)

What’s changed
- Closed underweight position in emerging markets (EM) equities
- Closed underweight position in international developed market equities
- Increased underweight in US government bonds
- Opened overweight in senior loans
- Opened underweight in preferreds

Implementation guidance

The macro and financial market outlook has become balanced in our view, after risks skewed to the downside in the summer. A US-China Phase 1 trade deal now looks likely, though not a certainty, while manufacturing sentiment and production appear to be stabilizing globally and could accelerate in 2020 if tariffs are rolled back. Consequently, this month we closed our tactical underweight to equities versus fixed income, moving to a neutral asset allocation. We still see upside in equities globally over the next 6-12 months, but for now the good news on trade and growth is largely priced into the markets.

Equities
We closed our underweights to emerging market and international developed market equities and now have a neutral allocation across those two regions and the US. If global growth continues to improve, international equities should outperform US stocks, as they have since late August. They’re biased toward value and cyclical stocks, which should do well as global growth rises back to long-term trend, whereas US equities have a growth and defensive tilt. Additionally, US equities are at all-time highs, while developed and emerging markets are about 10% and 20% below their respective peaks.

At a more granular level, we continue to prefer Japanese equities over Eurozone within developed markets. The former should more directly benefit from improving growth and they’re less expensive. US equities are also more attractive than Eurozone stocks within an all-equity portfolio because of their defensive properties in case tail risks materialize. We continue to prefer China and Brazil within EM. China is attractive on the prospect of a trade deal and more policy stimulus, while Brazil stands out for an improving macro outlook stemming from progress on major structural reforms.

Among US equity sectors, we shifted to a more balanced allocation by closing the underweight to industrials and the overweight to consumer staples. We continue to overweight consumer discretionary (consumer spending is solid) and communication services (defensive growth) sectors, which are offset with underweights to energy (still oversupplied oil markets) and tech, which appears expensive relative to the overall market.

Fixed income
We maintain our overweight position to emerging market US dollar-denominated sovereign bonds. These bonds have an attractive yield near 5%, with less credit risk compared to corporate bonds with similar yields. We maintain a position in TIPS versus US government bonds to position for rising inflation expectations, which have risen modestly month-on-month. They’re inexpensive, and lifting them is a primary goal for the Fed. We increased our US government bond underweight to fund the closing of our equity underweight positions.

In our Sustainable portfolios we keep our overweight position to environmental, social and governance (ESG) engagement high yield bonds versus ESG investment grade leaders bonds and ESG leaders equities. Additionally, we maintain a preference for green bonds versus ESG corporate bonds. The former have similar duration, but they’re more defensive due to their sector composition.

A note on TAA scaling
Unless noted otherwise, the TAA percentages on this page refer to a Moderate risk profile. Generally speaking, we apply a scaling methodology to TAA tilts for lower-risk portfolios, so that a 2% overweight in the moderate risk profile reflects as a 1.5% and 1%, respectively, in the Moderately Conservative and Conservative profiles.
Non-taxable investor
Moderate risk, without non-traditional assets

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Overweight: Tactical recommendation to hold more of the asset class than specified in the moderate risk strategic asset allocation. Underweight: Tactical recommendation to hold less of the asset class than specified in the moderate risk strategic asset allocation. Neutral: Tactical recommendation to hold the asset class in line with its weight in the moderate risk strategic asset allocation.

“Emerging Markets Fl” is a blend of 50% local currency, 50% hard currency.
Source: UBS

Risk profile implementation guidance

Tactical positioning for the Moderate portfolio is applicable for other risk profiles, with adjustments. We continue to recommend a long-maturity Treasury allocation in Moderately Aggressive and Aggressive portfolios, which have large equity allocations. These bonds are very effective diversifiers, but the interest rate risk that they entail is less desirable in Conservative portfolios. The recent rise in longer-maturity yields highlights this risk, and while that has made these bonds more attractive generally, the risk of yields continuing to rise makes us cautious about adding exposure at this time.

In Aggressive portfolios we recommend implementing the long-maturity Treasury position with 20-30 Treasury STRIPS (principal-only bonds), whereas 20+ year Treasury bonds offer sufficient protection for Moderately Aggressive portfolios. STRIPS have longer duration and thus offer more protection during a sustained economic slowdown when rates are likely to fall, but they’re also more volatile.

The Treasury inflation-protected securities (TIPS) allocation is appropriate for all risk profiles, but longer-maturity TIPS (10+ years) are better for Aggressive portfolios because of their longer duration. In Conservative portfolios, shorter maturities (0-5 years) are recommended because they have lower rising rate risk.
Investment Committee

Global Investment Process and Committee description
The UBS investment process is designed to achieve replicable, high-quality results through applying intellectual rigor, strong process governance, clear responsibility, and a culture of challenge.

Based on the analyses and assessments conducted and vetted throughout the investment process, the Chief Investment Officer (CIO) formulates the UBS Wealth Management Investment House View (e.g., overweight, neutral, underweight stances for asset classes and market segments relative to their benchmark allocation) at the Global Investment Committee (GIC). Senior investment professionals from across UBS, complemented by selected external experts, debate and rigorously challenge the investment strategy to ensure consistency and risk control.

Global Investment Committee composition
The GIC is comprised of 9 members, representing top market and investment expertise from across all divisions of UBS:

- Mark Haefele (Chair)
- Jorge Mariscal
- Mike Ryan
- Simon Smiles
- Tan Min Lan
- Themis Themistocleous
- Paul Donovan
- Bruno Marxer (*)
- Andreas Koester

WMA Asset Allocation Committee description
We recognize that a globally derived house view is most effective when complemented by local perspective and application. As such, UBS has formed a Wealth Management Americas Asset Allocation Committee (WMA AAC). WMA AAC is responsible for the development and monitoring of UBS WMA’s strategic asset allocation models and capital market assumptions. The WMA AAC sets parameters for the CIO Americas, WM Investment Strategy Group to follow during the translation process of the GIC’s House Views and the incorporation of US-specific asset class views into the US-specific tactical asset allocation models.

WMA Asset Allocation Committee composition
The WMA Asset Allocation Committee is comprised of nine members:

- Mike Ryan
- Michael Crook
- Brian Rose
- Jeremy Zirin
- Jason Draho
- Tom McLoughlin
- Leslie Falconio
- Laura Kane
- David Lefkowitz

(*) Business areas distinct from Chief Investment Office Americas, Wealth Management

Cautionary statement regarding forward-looking statements
This report contains statements that constitute “forward-looking statements,” including but not limited to statements relating to the current and expected state of the securities market and capital market assumptions. While these forward-looking statements represent our judgments and future expectations concerning the matters discussed in this document, a number of risks, uncertainties, changes in the market, and other important factors could cause actual developments and results to differ materially from our expectations. These factors include, but are not limited to (1) the extent and nature of future developments in the US market and in other market segments; (2) other market and macro-economic developments, including movements in local and international securities markets, credit spreads, currency exchange rates and interest rates, whether or not arising directly or indirectly from the current market crisis; (3) the impact of these developments on other markets and asset classes. UBS is not under any obligation to (and expressly disclaims any such obligation to) update or alter its forward-looking statements whether as a result of new information, future events, or otherwise.
Explanations about asset classes

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

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

The process by which the strategic asset allocations were derived is described in detail in the publication entitled “Strategic Asset Allocation (SAA) Methodology and Portfolios.” Your Financial Advisor can provide you with a copy.

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

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

Asset allocation does not assure profits or prevent against losses from an investment portfolio or accounts in a declining market.

Statement of risk
Equities - Stock market returns are difficult to forecast because of fluctuations in the economy, investor psychology, geopolitical conditions and other important variables.

Fixed income - Bond market returns are difficult to forecast because of fluctuations in the economy, investor psychology, geopolitical conditions and other important variables. Corporate bonds are subject to a number of risks, including credit risk, interest rate risk, liquidity risk, and event risk. Though historical default rates are low on investment grade corporate bonds, perceived adverse changes in the credit quality of an issuer may negatively affect the market value of securities. As interest rates rise, the value of a fixed coupon security will likely decline. Bonds are subject to market value fluctuations, given changes in the level of interest rates. Not all bonds can be sold quickly or easily on the open market. Prospective investors should consult their tax advisors concerning the federal, state, local, and non-U.S. tax consequences of owning bonds, given changes in the level of interest rates. For example, if interest rates rise, the value of these securities could decline. If preferred stocks are sold prior to maturity, price and yield may vary. Adverse changes in the credit quality of the issuer may negatively affect the market value of the securities. Most preferred securities may be redeemed at par after five years. If this occurs, holders of the securities may be faced with a reinvestment decision at lower future rates. Preferred stocks are also subject to other risks, including illiquidity and certain special redemption provisions.

Municipal bonds - Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond’s sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor’s total return. Because of the large number of municipal issuers and credit structures, not all bonds can be sold quickly or easily on the open market.
Emerging Market Investments

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


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

Nontraditional Assets

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

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

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

Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-US securities and illiquid investments.

Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.

Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.

Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.

Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in US dollars, changes in the exchange rate between the US dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a US investor.
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