

Panorama

For marketing purposes
For global professional /
qualified / institutional clients
and investors and US retail
clients and investors.

Mid-Year 2021 | UBS Asset Management



Economy in recovery

06 | 2021's five
#trending topics

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future belong
to Asia?

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here to stay

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green transition

In this edition of Panorama, our senior asset class and asset allocation experts assess the potential challenges and opportunities investors face amid rising inflation.

The following pages offer distinct viewpoints and investment insights across our global capabilities, to help meet your investment challenges.

For additional content and previous editions of Panorama, including videos and additional in-depth investment insight, visit ubs.com/panorama or scan the below QR code.



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Barry Gill
Head of Investments

...the pandemic has awoken in all of us a respect for how fragile our society and planet are...

A shifting momentum

What a difference a year makes!

In 12 months, the mood of the markets has swung from one of fear and pessimism to one of unbridled optimism. Despite my many years in this business I never cease to be surprised by how the market's perception of the long-term volatility of corporate cashflows is completely out of kilter with reality.

But I should not complain, and am not complaining, because it is this phenomenon that presents a recurring, rich seam of opportunities to be mined by patient capital.

The net result of this swing in emotion is that the S&P 500, the Euro Stoxx and the MSCI Emerging Markets Index have all appreciated at least a third¹, industrial metals have almost doubled in price, while US Treasury yields have backed up 75 basis points and the US Dollar has weakened significantly.¹

Now, unsurprisingly, it is time for the market to worry about a new set of risks, like whether the current inflation trends are cyclical or structural; how society is going to pay for all the stimulus of the last year; and how the world's two largest economic powers plan to coexist.

Additionally, the pandemic has awoken in all of us a respect for how fragile our society and planet are, and how they must be protected; it has focused investors' minds on the extremity of the economic and demographic imbalances in the West that have arisen through globalization, and on the environmental damage caused by our relentless adherence to GDP growth as a barometer of progress.

Rather than being a casualty of the pandemic, sustainable investing has become more embedded than ever.

¹ Source: Bloomberg, June 2021

Are we now in a world where the concept of investing in emerging markets is broken, given that Asia is becoming so investible on its own?

In our mid-year edition of Panorama, we take stock of the various dynamics influencing the markets today and evaluate what that means for our long-term asset return assumptions.

We take a deep dive into the Asian economy and the investment opportunities arising across asset classes from the growth of China and its ever-increasing relevance to the welfare of its major Asian trading partners. Are we now in a world where the concept of investing in emerging markets is broken, given that Asia is becoming so investible on its own?

Then we move on to a discussion of why we believe the time is right for investors to increase their allocations to hedge funds. Hedge funds have largely been left behind in last decade's reallocation towards alternatives, but with asset prices in aggregate so high the time is likely right to focus on alpha as a driver of return as opposed to just beta, which has been such a powerful prevailing wind for so long.

Finally, consistent with our focus on sustainable investing, we preview a white paper our data science team, QED, and Bruno Bertocci, Head of the Global Sustainable Equities team, are collaborating on. In it we explore a concrete way for companies and clients to model the cost of their carbon footprint in their capital allocation and valuation frameworks. It will also provide the quantifiable basis for how we engage with companies on this topic on behalf of our investors.

I hope you find our mid-year update both informative and provocative as you navigate markets. Please don't hesitate to contact your UBS Asset Management partner should you seek further insight.

We look forward to our continued partnership with you throughout the next year.



2021's five #trending topics

Global macroeconomic and tactical asset allocation **outlook**



Evan Brown
Head of Multi-
Asset Strategy,
Investment
Solutions

We came into 2021 with a broadly positive outlook for the global economy as we progress towards a more durable, comprehensive reopening. So what does this mean for procyclical positions across asset classes that have served us well so far this year?



Ryan Primmer
Head of Investment
Solutions

We expect a choppier environment for equities at the headline level, which tends to happen in the second year of a new bull market. We believe that the equity risk premium is near the floor of the previous cycle, which may cap near-term upside in stocks as policy risks start to become more two-sided. The recent hawkish turn by the Federal Reserve threatens to undo some of the weakness in the US dollar year-to-date, though there may still be areas of outperformance in emerging market currencies of countries where central

banks have already been aggressively raising rates and are poised to continue doing so. This development may foster more volatility in relative value procyclical positions across asset classes. Robust activity and lingering upside inflation risks should lead to higher yields over time.

Against this backdrop, we pose five key questions that could dictate absolute and relative performance across asset classes in the second half of the year, and look at how this informs our current positioning.

Inflection points in growth are not expected to be synchronous, so we believe investors should migrate towards earlier-cycle environments, such as Japan or specific emerging market countries.

1 Should investors embrace equity market beta, or the relative equity positions that worked in the first half of the year?

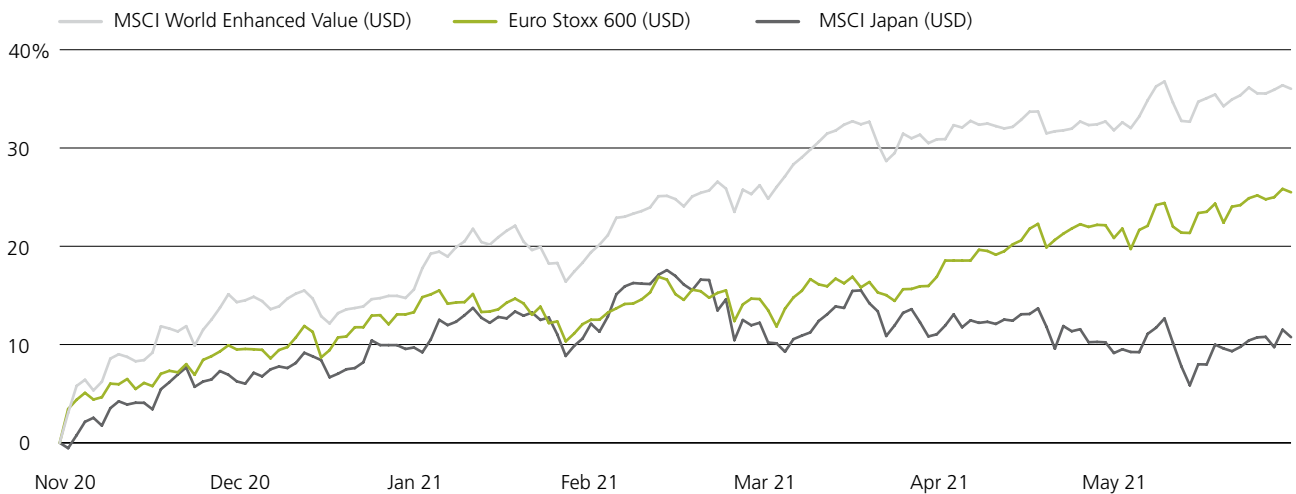
The common thread running through equity markets in the first half of the year saw stocks levered to strength in real economic activity outperform, while more defensive or secular growth stocks struggled. We believe that this theme is likely to experience more challenges and two-way moves, particularly in the near

term, but ultimately remain intact in the back half of 2021. What is also different is that we have a more rangebound outlook for equities at the index level after robust gains during the first six months of the year.

There are times to run higher levels of risk, and times to run lower levels. In the near term, we believe the latter is more appropriate. We prefer procyclical relative value positions compared to a

significant overweight stance on equity beta. Inflection points in growth are not expected to be synchronous, so we believe investors should migrate towards earlier-cycle environments, such as Japan or specific emerging market countries. Global growth is poised to peak, but we expect the expansion to remain robust thereafter. Near-term volatility may provide windows of opportunities to selectively add to some early-cycle positions.

After strong value outperformance, cyclically-oriented regions may have more room to run



Source: UBS Asset Management, Bloomberg, May 2021



2 How does a hawkish pivot from the Federal Reserve change the outlook for the second half?

At its June meeting, Fed officials signaled that it may be appropriate to raise rates twice in 2023 – up from expectations that rates would stay at zero through that year. This glide path was more hawkish than anticipated. We believe this marks a transformation from the Federal Reserve acting primarily to suppress market volatility, as was the case throughout the COVID-19 crisis, to being more of a source of market volatility.

Monetary support has been critical in underpinning equity valuations. Now, investors may have to grapple with the prospect of a withdrawal of accommodation sooner than had previously been anticipated. Going forward, the underlying moves in the bond market will be crucial to setting the tone for other asset classes. Continued upward pressure on real yields, with breakevens moving lower, is not a constructive combination for risk assets like equities, credit spreads, and commodities.

However, it is important to appreciate the context in which monetary stimulus might start to be removed. The US central bank has more faith in the economic recovery – which is ultimately what will be needed to deliver continued earnings growth. In addition, the central bank is looking to curtail the kind of right-tail inflation risks that could prove disruptive to the expansion, risk assets, and common portfolio structures. So too must this shift by the Federal Reserve be balanced against other underlying economic trends, chiefly the upward convergence of global activity with that of the US.

In the short term, the Federal Reserve's decision may elicit a meaningful reversal in particularly buoyant and vulnerable pockets of reflation trades. But over time, particularly if US inflationary pressures begin to subside, the strong, broadening global economic recovery should emerge as the dominant driver of absolute and relative performance across asset classes. And if US inflationary pressures begin to subside in the second half, as we anticipate, this likely reduces the likelihood that additional hawkish Fed surprises will be in the offing.

3 How will recently discussed and upcoming legislation from the US Congress affect markets?

The US is likely to pass additional fiscal stimulus in 2021 that includes both physical and social infrastructure – but also tax hikes. This is the crucial implication for financial markets: fiscal policy risks stateside are now two-sided.

There is a tentative bipartisan agreement in the Senate to boost spending on physical infrastructure by USD 579 billion, without any new taxes. If passed, the bill is likely to be signed by the White House in the third quarter.

Congressional Democrat leaders have made statements indicating that they are planning on advancing a separate bill through the reconciliation process on a parallel track. Their aim, in our view, is to make sure that policy priorities such as social and green infrastructure are more fully addressed ahead of the midterm elections in 2022. This second bill is unlikely to be passed until the fourth quarter.

A lesson from earlier rounds of stimulus passed in 2021 is to not underestimate the eventual size of the total spending



and revenue-raising measures in a second bill that has only Democratic support. Constraints on the size of this spending, as well as tax increases, will be set by more centrist senators from the Democratic Party as opposed to Republicans. However, some of the potential line items are more controversial than spending on physical infrastructure. This may result in the cumulative spending in the two bills rather than under an alternative scenario in which only one infrastructure bill is passed with only Democratic support. If the bipartisan deal falls apart, we would expect Democrats to quickly pivot to doing one big package through reconciliation.

Attempts to raise revenues are likely to face much stiffer opposition than any of the expenditures. If there ends up being two bills, we would expect the second to include approximately USD 2 trillion in additional spending somewhat offset by up to USD 1.5 trillion in corporate, personal income, and capital gains taxes. This spending will be spread out over a period of many years, so the more timely consideration for markets are the tax changes. In our view, investors have not displayed much concern about the prospect of higher taxes, and this should change.

The corporate tax rate is likely to increase to at least 25%, but will remain well below levels that prevailed prior to the 2017 Trump tax cuts. The key point is that the net effect of this package will be a reduction in the after-tax earning power of US companies. This supports our preference for ex-US developed market equities.

In addition, Democrats are likely to include some revenue-raising measures that have a negative impact on multinational firms and mega-cap technology companies. All else equal, this should be a headwind for US growth stocks.

4 Can Europe avoid repeating the policy mistakes of last cycle?

We expect to see Europe clear this very low bar with ease: in our view, there will be no abrupt lurch towards fiscal austerity, and the European Central Bank is not expected to hike rates amid a temporary bout of inflation.

The eurozone is relatively unique in that growth is not likely to decelerate from 2021 to 2022. This is partially attributable to the delayed services recovery, but also a testament to the anticipated capital spending resurgence as well as enhanced support from the

EU recovery fund – and the high likelihood that restrictions on government deficits will once again be suspended. Plans from European governments indicate that fiscal consolidation will be modest thereafter.

The German election in late September looms large as a catalyst for European assets. In the near term, political risks in Europe (and in particular Germany) are two-sided but asymmetrically skewed towards a more permissive stance regarding government deficits, higher public investment, and more economic integration.

As such, the persistent valuation headwinds for European assets during the pre-COVID cycle are well-positioned to turn to tailwinds during this expansion, in our view. Right now, earnings for European companies are poised to grow faster than those of their US counterparts despite slower economic growth in Europe vs. the US.

We are closely watching the results of the German election and the longevity of the bounce back in business investment to judge whether both the public and private sector outlooks continue to support the outperformance of European assets.



Other procyclical trades like emerging market currencies and the S&P 500 equal weight vs. market cap have proceeded to fresh cycle highs.

5 Does the deceleration in Chinese credit growth jeopardize procyclical positions?

The moderation in Chinese credit growth is the chief identifiable risk on the macro horizon. Based on investors' muscle memory from the pre-pandemic expansion, this threatens to introduce volatility that challenges procyclical positioning, particularly in emerging market assets.

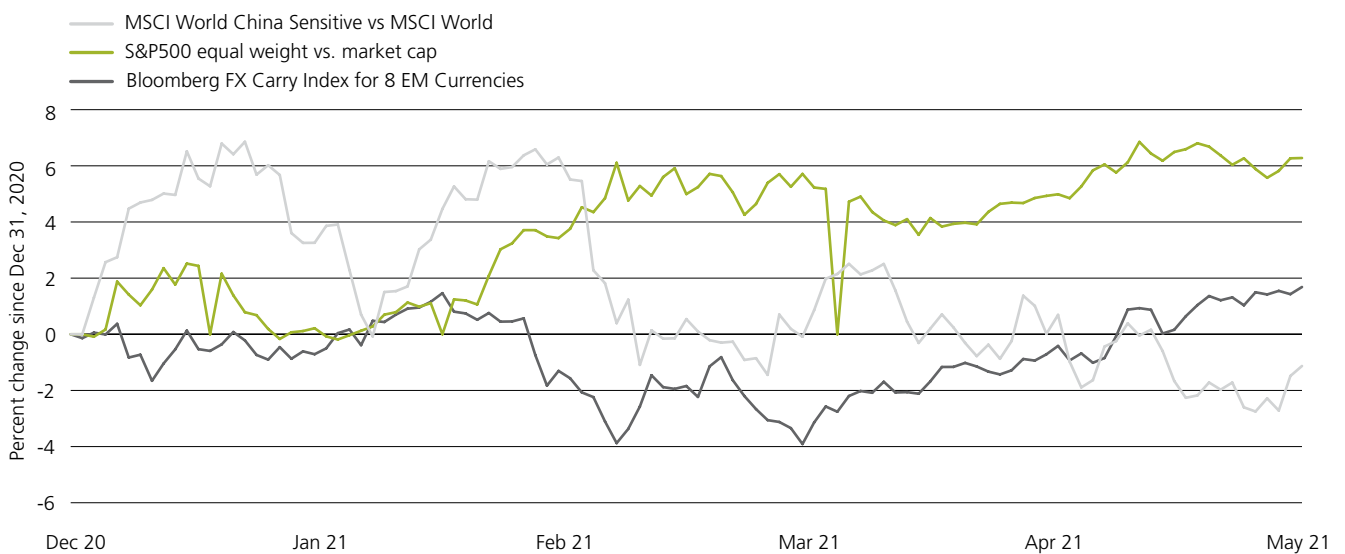
Ultimately, we believe this risk will be overcome by the broader suite of tailwinds for global activity and the relatively modest nature of Chinese policy tightening.

Nominal GDP growth in China is strengthening even as total social financing softens. Reopening is allowing for a steady pickup in consumer spending, the rebound in industrial profits supports capital expenditures, and the robust backdrop for external demand buoys Chinese exports.

Markets are already expressing a more nuanced view on the ramifications of fading Chinese growth leadership. Global companies with exposure to China peaked in January. Other procyclical trades like emerging market currencies and the S&P 500 equal weight vs. market cap have proceeded to fresh cycle highs.

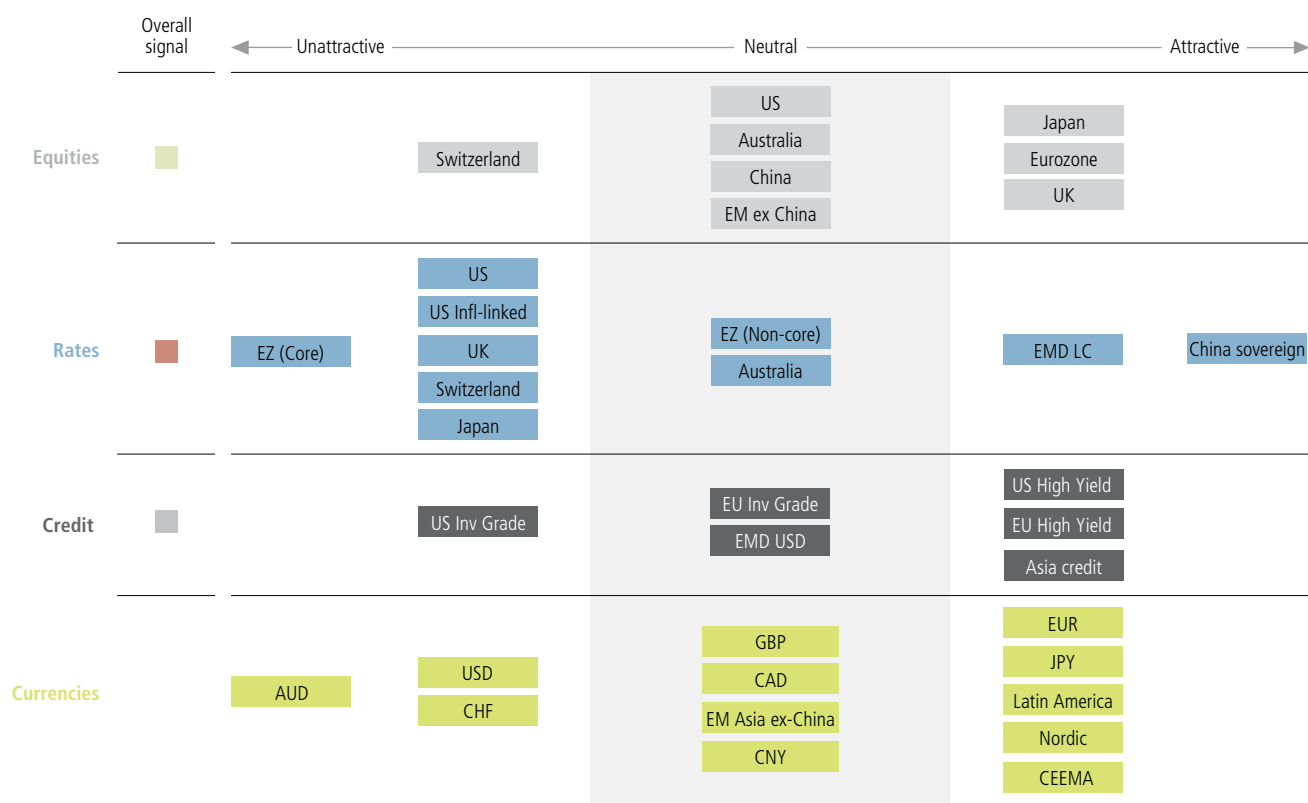
What is different this time: the large stock of global fiscal stimulus that underpins global trade, the supply chain struggles that should prolong early-cycle dynamics in goods sectors, EM central banks are turning more hawkish, and years of underinvestment is fostering shortages across many commodity markets. These factors create a more supportive outlook for procyclical positions, including EM currencies, though such trades face an additional headwind in the near term due to the Fed's more hawkish tilt.

China concerns not weighing on broad procyclical positioning



Source: UBS Asset Management, Bloomberg, Percent change May 31 2021

Traditional asset classes and currencies – as of June 2021



Source: UBS Asset Management's Investment Solutions Macro Asset Allocation Strategy team as at June 21 2021. Views are provided on the basis of a 3–12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

The five-year market perspective

Longer-term **stock return potential**



Louis D. Finney
Co-Head of
Strategic Asset
Allocation
Modeling

We explore four different growth-inflation scenarios and the potential impact on traditional portfolios. The results underscore the importance of alternative assets as a portfolio diversifier.

Our Investment Solutions team provides estimates of capital market returns across a wide array of asset classes and from multiple currency perspectives with a focus on our five-year baseline expected geometric returns.

Although the recovery has at times sputtered, we estimate that pent-up demand, highly accommodative government policies, newfound productivity from working from home and reshuffling of workers into more productive activities should keep growth in the 2.0% range.

Changes in the macro environment

Our inflation estimates have moved up slightly, though not as dramatically as changes in breakeven rates imply. Although we see short-run inflationary pressures, we expect central banks to be successful in controlling inflation. We tend to side with the Fed that this is a temporary spike in inflation and that the deflationary forces of technology and a high degree of substitution will keep sustained inflation in check.

The global 60/40 approach continued to have solid returns. A 60% MSCI ACWI unhedged and 40% Bloomberg Barclays

China continues to have a different business and market cycle than the rest of the world.

Global Aggregate hedged return 31.2% in the past year and 9.8% over last five years. However, on a forward looking basis, we have lowered our return expectations.²

We expect the stock-bond correlation to continue to be negative, though the relationship has weakened a bit and is vulnerable to a reversal with a breakout of inflation and possible Fed interest rate hikes.

We view China as unique: neither a developed nor an emerging market, it continues to offer unique diversification benefits for global investors. China

continues to have a different business and market cycle than the rest of the world. The correlation of Chinese equities with the S&P 500 (local to local currency) was 0.03 over the past year. In fixed income, Chinese government bonds continue to have a low correlation with other government bond markets, despite the recent deceleration in Chinese credit growth.³

With equities rallying 14.2%⁴ from November through April, valuations have become even more stretched and will require extraordinary earnings growth and continued low rates to be justified.

Although cash rates barely budged, government bond yields in developed markets moved up anywhere from 8 bps (Japan) to 89 bps (Canada). The emerging markets also saw a substantial increase in yields. China is one outlier, with their benchmark 10-year government bond yield declining by 9 bps.⁵

In general, with the US dollar getting closer to fair value, we see limited gains from currency exposure for unhedged non-USD assets in USD terms. Conversely, we see smaller losses for foreign investors investing in USD-denominated assets.

² Data from Macrobond, calculation by UBS Asset Management. Data as of 30 April 2021.

³ Data from Morningstar, calculation by UBS Asset Management. Data as of 30 April 2021.

⁴ MSCI AWCI in USD from 30 Nov 2020 to 30 April 2021 (five months).

⁵ Data from Morningstar, Macrobond, calculation by UBS Asset Management.

Inflation and capital market expectations: Four scenarios

One of the biggest market concerns is a sustained bout of inflation. For at least a decade, global inflation has missed central bank targets⁶. Heightened concern is warranted, as a flood of debt issuance that can't be absorbed in the market may ultimately cause inflation. It can be argued that we already see this in asset prices and now the real economy is catching up to this.

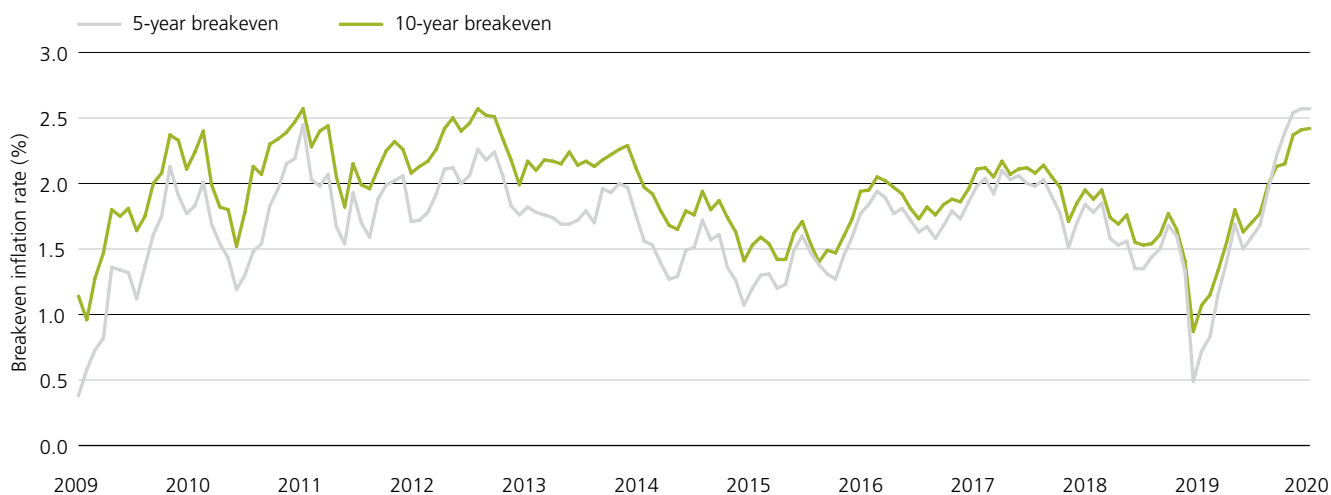
Short-term measures of inflation have risen sharply in the past few months. Back in November breakeven rates were around the average inflation rate for the last dozen years (1.7%). But in 2021 inflation has shot up 70 to 90 basis points to hover around 2.6% for the US.

One interesting recent development is that shorter-term measures of expected inflation are higher than longer-term measures.

For example, the 5-year breakeven Inflation rate, the difference between nominal Treasury and inflation-adjusted real Treasury yields as measured in the TIPS market, is 2.6% while the 10-year is 2.4%.

And the 1-3 TIPS sector compared with the 1-3 Treasury sector indicates a 2.8% inflation rate.

US breakeven inflation: 2009–April 2021



Source: Macrobond, UBS Asset Management. Data as of 31 May 2021.

⁶ For example, since 2009, the Fed has targeted 2.0% inflation on a Core PCE basis. However, Core PCE has averaged about 1.6% over this period. The 'headline' inflation figure (CPI-U All Items) has been a bit higher at 1.8%.

We explore four different inflation scenarios. In each of these scenarios we are assuming a continuation of growth and above-average inflation in the second half of 2021.

Thus, the negative and positive effects begin to show themselves in early 2022.

1. Growth inflation: strong growth and high inflation
2. Baseline: moderate growth and moderate inflation
3. Stagflation scenario: low growth and high inflation
4. Stagnation: recession in late 2022 followed by low growth and low inflation

When analyzing scenarios, we combine growth and inflation to produce nominal growth rates. We project that nominal growth could be as high as 6.3% and as low as 3.0%. However, we ultimately want to judge returns in real terms and significant differences in inflation can cause a notable difference between the nominal and real results.

5-year scenario analysis

Scenario	Nominal rate	Real growth	Inflation
1. Inflationary growth	6.3%	3.1%	3.1%
2. Base	4.6%	2.4%	2.1%
3. Stagflation	4.7%	1.5%	3.1%
4. Stagnation	3.0%	1.5%	1.5%
20-yr average current (2021)	3.8%	1.9%	2.1%
20-year average 2001	6.2%	3.3%	3.5%
20-year average 1981	9.1%	3.9%	5.6%

Source: UBS Asset Management. Data as of 30 April 2021. Inflation expectations are set by UBS Asset Management.

Projected annualised 5-year returns through June 2026

	Nominal terms				Real terms				Range	
	1. Inflation growth	2. Base	3. Stagflation	4. Stagnation	1. Inflation growth	2. Base	3. Stagflation	4. Stagnation	Nominal	Real
US Large Cap Equity	7.7%	3.9%	0.2%	0.2%	4.4%	1.9%	-2.9%	-1.2%	7.5%	7.2%
1-3 yr Treasury	0.4%	0.2%	0.1%	0.1%	-2.7%	-1.8%	-2.9%	-1.3%	0.2%	1.6%
1-3 yr TIPS	0.9%	-0.3%	0.6%	-0.3%	-2.2%	-2.3%	-2.4%	-1.8%	1.2%	0.6%
1-3 yr Credit	0.7%	0.5%	0.5%	0.5%	-2.4%	-1.5%	-2.6%	-1.0%	0.2%	1.6%
10-yr Treasury	-0.4%	1.1%	0.1%	1.6%	-3.4%	-1.0%	-2.9%	0.1%	2.0%	3.5%
10-yr TIPS	0.7%	0.0%	1.4%	-0.3%	-2.3%	-2.0%	-1.6%	-1.7%	1.7%	0.7%
US Inv Grade Credit	0.2%	1.3%	0.3%	1.4%	-2.8%	-0.8%	-2.8%	-0.1%	1.1%	2.7%
US High Yield Credit	2.2%	1.7%	1.1%	1.5%	-0.9%	-0.4%	-2.0%	0.0%	1.1%	2.0%
Commodities	5.3%	2.0%	4.8%	-1.8%	2.1%	0.0%	1.6%	-3.2%	7.0%	5.3%
Gold	2.0%	2.0%	4.5%	1.0%	-1.1%	0.0%	1.4%	-0.5%	3.6%	2.5%
Cash	1.4%	0.7%	0.1%	0.0%	-1.7%	-1.3%	-2.9%	-1.4%	1.4%	1.6%
Inflation	3.1%	2.1%	3.1%	1.5%						

Source: UBS Asset Management. Data as of 30 April 2021.

When we look at real returns across these four scenarios, we find no asset class generates a positive real return across all scenarios, and fixed income is locked into negative real returns in almost all scenarios.

Portfolios invested entirely in equities and fixed income have no place to hide if inflation were to jump to the 3.0%+ range for an extended period.

Alternatives offer a potential source of protection. Like equities, real estate's

brightest days may be behind them, but steady returns with some ability to ratchet up income as inflation increases should do better than fixed income and rival US equity returns in all scenarios, though stagflation would clearly be the worst.

We expect alternatives to suffer the least as commodities, gold and real estate gain relative to other asset classes.

Forward looking expectations

Our expected returns for equities – especially US equities – are the lowest in years. Pockets of equities outside the US offer more compelling returns. Offsetting this is an increase in government bond yields, though this has stabilized in the last couple of months.

When it comes to asset returns and inflation, we see that the market is little prepared for a big breakout. In the short run there is no place to hide from negative real returns.

We expect alternatives to suffer the least as commodities, gold and real estate gain relative to other asset classes. Again, the backdrop to the type of inflation is important. Growth

inflation should benefit real estate, while a Stagflation outcome would probably be very positive for gold. Commodities would probably be one of the drivers in inflation and clearly should do better in an inflationary growth environment.

In short, the market opportunities to truly profit from inflation are few.

Does the future belong to Asia?

Asia's rising importance in the world economy



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Vivien Ng
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Global Emerging
Markets and Asia
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With rising incomes and an ever-increasing population, Asia's rising importance in the world economy is becoming even clearer. But what are the key drivers to stronger Asian economies and what is setting it apart from its emerging market peers?

If we look at Asian companies, what we see is pretty good health, there's no buildup of excess capacity, and cash as a percentage of assets is at a historical high. Similarly, debt is near a historical low.

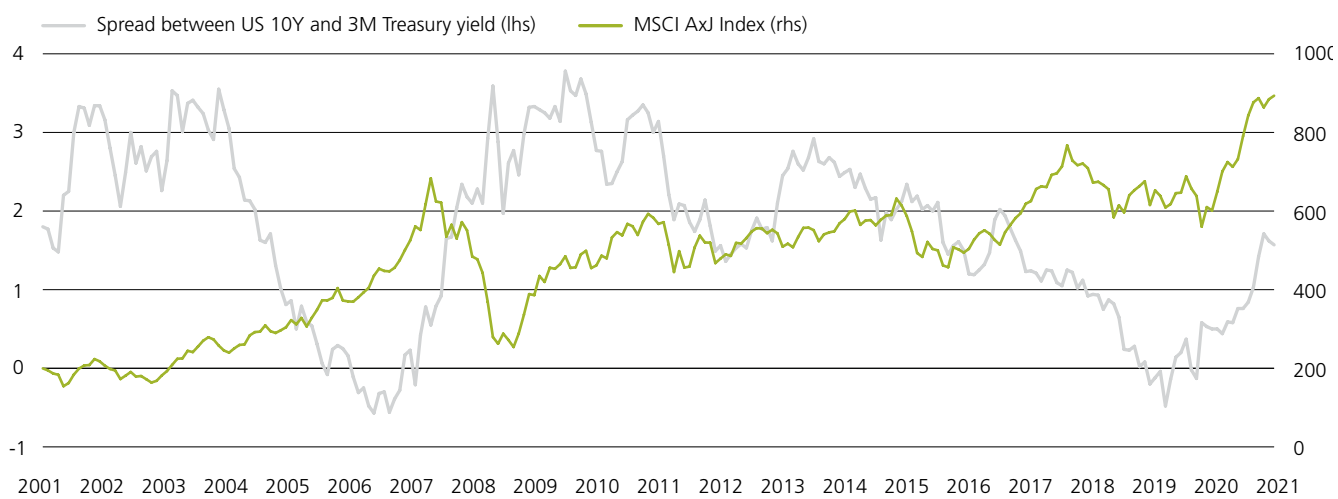
A steepening yield curve may be good for Asia

Recently there's been some fear about rising bond yields. Historically, there's been a rather loose correlation between the equity index and the yield curve. We

believe the steepening yield curve is signaling stronger US economic growth which has generally been positive for Asian equities. So we're not too concerned about rising rates at the long end.

Looking at valuations, no asset class is cheap, but when we look cross-sectionally at Asian equities, it is one of the cheaper of the major asset classes.

US yield spread vs MSCI Asia ex Japan index



Source: Factset, as at 31 May 2021

Secular growth drivers are key for long-term investors

When looking at fundamentals, we believe specific themes will provide secular growth drivers for some companies in Asia, including:

Changing consumer patterns

As consumers become more affluent, consumption patterns are moving from basic functional brands to premium brands.

E-commerce

Digital transformation is taking place and e-commerce penetration is increasing. Some Asian countries, like India and Indonesia, have low penetration, but we expect they will catch up.

Innovation

Asian companies are innovating – filing more patents than in the US and Europe combined in 2020⁷ – and they are spending more on R&D than companies in the US and Europe⁸.

Growth of financial services

When Asian economies develop, credit markets will likely grow faster than GDP, opening opportunities for banks to take market share.

⁷ Source: World Intellectual Property Organization, October 2020

⁸ Source: R&D World, March 2020

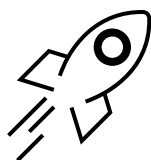
Asia small caps offer opportunities

Looking deeper into Asia, we believe the small cap space may offer investors profitable opportunities, and here are four specific reasons why:



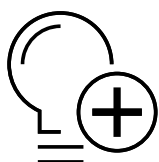
Higher alpha opportunity

As small and mid cap companies are under researched, this creates more opportunities for investors to outperform by exploiting knowledge inefficiencies.



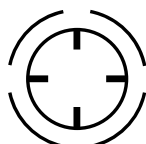
Higher growth

Through smaller companies, we believe investors can invest in structural themes at an earlier stage and benefit from a longer runway of growth.



Diversification

The Asia small cap universe is larger and more diversified than the large cap space, thus offering valuable diversification benefits.



Better focus

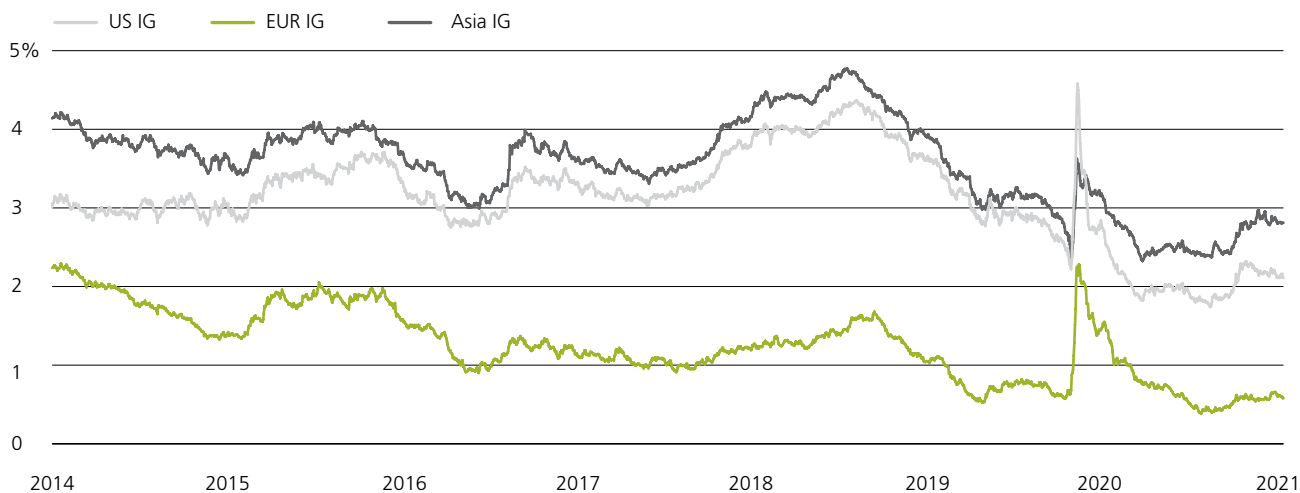
Large cap companies tend to be spread across different business lines while small cap companies can be more focused on specific areas.

Asia: the place to be for global bond investors?

Asia is displaying a strong recovery and we believe this will continue in 2021 and into 2022. So what does that mean for credit? It means there is a higher growth trajectory across Asia relative to the rest of the world due to higher earnings power and the ability to pay back debt.

When we look at Asia from a credit or yield perspective, Asia offers a substantial pickup in yield relative to US and Europe.

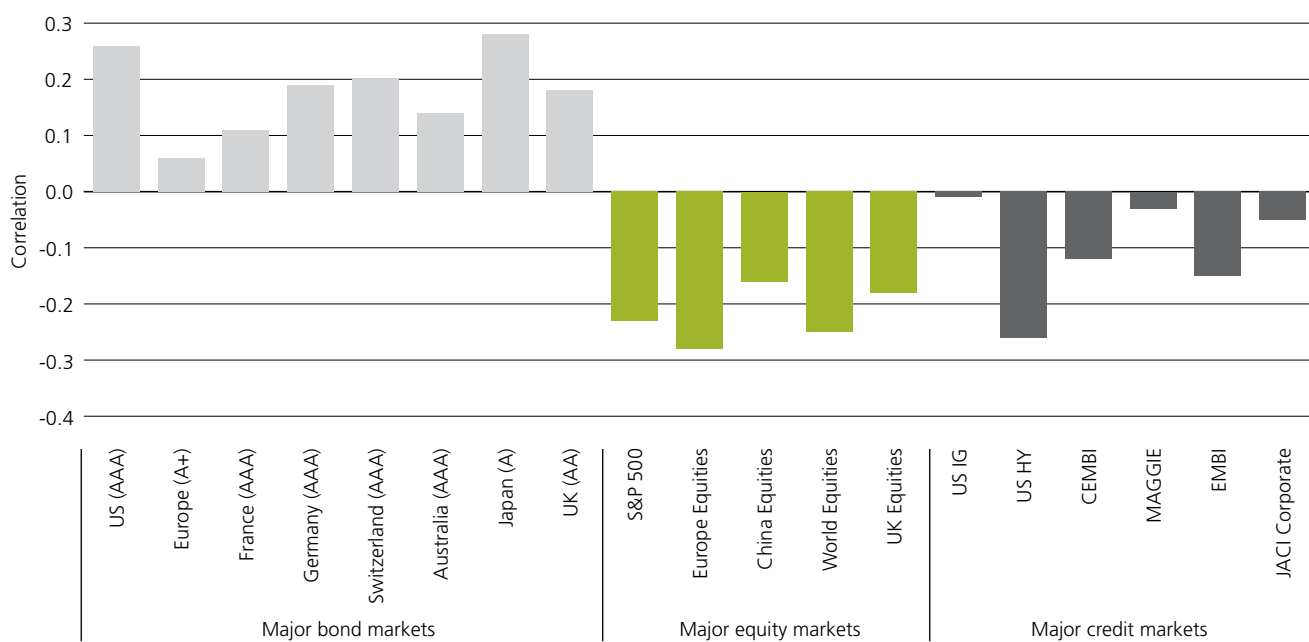
Investment grade credit market: Yields



Source: Bloomberg, as at 8 June 2021.

Note: US IG = Bloomberg Barclays US Corporate Total Return Index (LUACTRUU),
EU IG = Bloomberg Barclays Euro Aggregate Corporate Total Return Index (LECPTRU),
Asia IG = Bloomberg Barclays Asia USD Investment Grade Bond Index (BAIGTRU)

China bonds: five-year correlation with global asset classes



Source: Bloomberg, May 2021

Why China bonds?

China government bonds offer one of the highest nominal yields in the world today compared to other developed markets and are offering one of the highest real yields in the world today in bond markets. Chinese bonds historically have very low correlation to other developed market bond markets, as well as to equity and credit markets.

So, to sum up, we believe Asian credit looks like it offers a lot of value today relative to other markets. When we consider the risk, the assessment looks even better, particularly on the investment grade credit side. Hence from a nominal and real yield and correlation perspective, we think that Chinese bonds have a place in everybody's portfolio.

China A share's part in the Asian opportunity

China's A-share market is one of the largest in the world but remains underinvested by global investors. Here are four reasons why it's a market that investors can't ignore.

1

China's A-share market is dominated by retail investors. Retail investors have short holding periods, which can contribute to market volatility and create attractive entry points for active investors.

2

China's A-share market is a rich opportunity set. There are more companies in China's A-share market than offshore and particularly in fast-growing sectors like healthcare, consumer, and information technology.

3

China A-shares are relatively under-researched. Almost 70% of A-share companies are covered by three or less analysts, according to Reuters.

4

China A-shares historically have low correlation to overseas markets. China A-shares have, over time, shown low correlation to overseas markets because of low foreign ownership, controls on investor access, and the composition of the investor base.

Hedge funds: here to stay

An attractive **alpha environment**



Kevin Russell
CIO, O'Connor

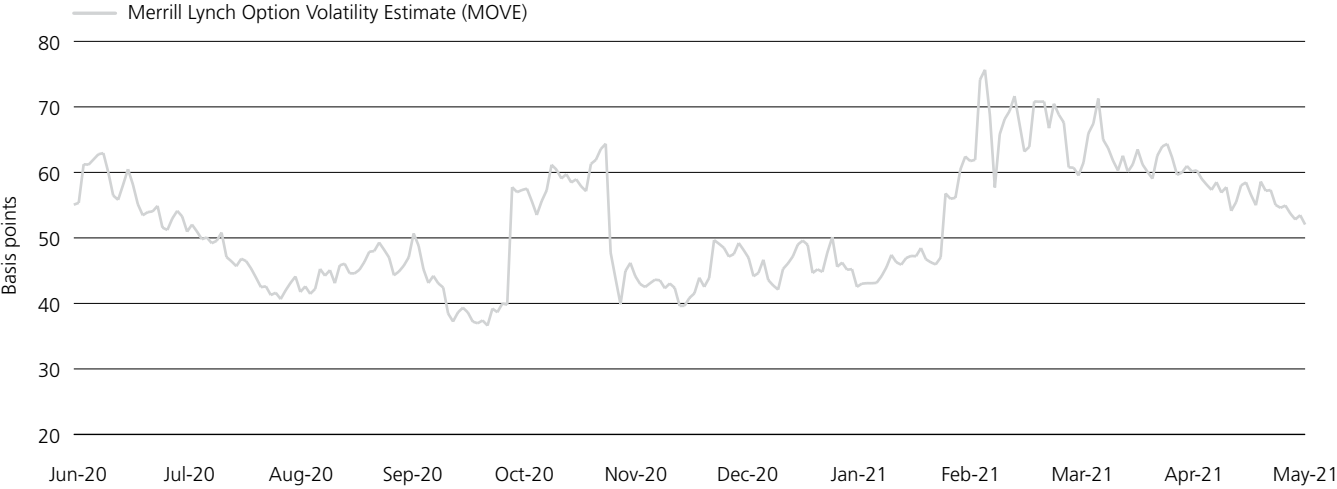
We believe the same cyclical and structural dynamics in markets that enabled strong hedge fund performance over the past two years are set to continue going forward, creating a favorable environment for hedge fund strategies.

Hedge funds have seen strong performance over the last two years, capitalizing on market dislocations and structural changes and these have created alpha opportunities that hedge funds are well positioned to take advantage of. We see those trends continuing, as market uncertainty continues to cause market dislocations.

Our preferred indicator for investor risk appetite is interest rate volatility, measured by the MOVE Index (Merrill Lynch Option Volatility Estimate), which spiked in first-quarter 2020 and again in early 2021. This year's elevated interest rate volatility has brought with it both risk aversion and violent factor rotations within equity markets.

Our preferred indicator for investor risk appetite is interest rate volatility...which spiked in first-quarter 2020 and again in early 2021.

Rising interest rate volatility suggests reduced investor confidence



Source: Bloomberg, UBS Asset Management. Data as of 31 May 2021.

Interest rates serve as the fulcrum point for the economy, providing a comprehensive view about growth, inflation, and policy. Obviously, interest rates play a central role in valuing any financial asset. But beyond the absolute level of rates, interest rate volatility creates equity market rotations and dislocations in the market, and we've seen that this year.

Put simply, when interest rate volatility is high, certainty about economic conditions and confidence in asset valuations is low, often manifesting itself as risk aversion amongst relative value investors, especially those who operate on leverage.

For the last decade or longer, investors became accustomed to low interest rates and expected interest rates and growth to continue at a low level. Growth, quality and bond-proxy names performed for over a decade under this regime, but now we are starting a new economic cycle and investors are going to have to adjust those rotations and exposures.

That process creates tremendous opportunities for investors like ourselves. We monitor and trade around factor exposures: in the first quarter of this year we achieved an entire year's worth of rotations in the market, from a consensus growth position towards one more balanced with value and cyclicals.

Financial markets generally do a very bad job when they first have to adjust to new economic realities and new market risks.

And so we see a lot of rotations and overcorrections, creating tremendous relative value opportunities.

Looking across asset classes, we believe equity markets have very two-sided risk. Duration assets have significant downside. Credit markets are largely priced for perfection, in our view.

We see a lot of rotations and overcorrections, creating tremendous relative value opportunities.

The current macro environment provides what we consider a perfect backdrop for hedge fund investors

Six mega trends creating opportunities

As for structural opportunities, we've been focused on six mega trends happening within the financial markets that are now creating systematic alpha opportunities for investors like ourselves.

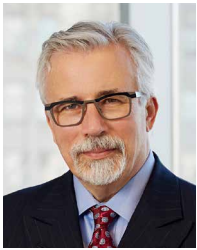
- 1 The first is the disintermediation of the banks and broker dealers in credit markets. The corporate credit markets have exploded in size, while banks and broker dealers who carry inventory are just too small relative to that notional amount of corporate debt, creating tremendous relative value opportunities for investors.
- 2 Secondly, the explosive growth in special purpose acquisition companies (SPACs). As of the middle of the second quarter of 2021, USD 91 billion of SPAC stocks looking for transactions, became a very important mechanism for emerging growth companies to come public, creating compelling relative value opportunities.
- 3 The third is the environmental space, against the backdrop of climate change, which is causing changes in consumer preferences, a dynamic regulatory landscape, and is generating significant shifts in capital expenditures. Those are the raw materials for dispersion of returns.
- 4 The fourth mega trend is the disintermediation of banks as hedge funds and asset managers extend credit directly to borrowers. Particularly in the case of riskier and more complex loans, banks are not willing and able lenders in many cases. This offers one of the most attractive, risk-adjusted yield and total return profiles available in the financial markets for private credit investors.
- 5 The fifth is trade finance, where we're seeing really compelling opportunities relative to what we see in investment grade and high yield bonds. These trade finance claims have a shorter duration, higher yield, lower default probabilities and higher recovery than corporate bonds, yet are complex enough that most investors cannot participate.
- 6 Finally, the sixth mega trend is China. At 17% of global GDP⁹, China has been working hard to make their markets more accessible and more efficient. This was underscored late last year, when China eased foreign access to its capital markets through a reform of its Qualified Foreign Institutional Investor (QFII) and Renminbi QFII programs that will allow investors to trade directly with Chinese banks and broker dealers and create an onshore stock lending market over time. China's robust capital market calendar, unique pools of liquidity and the corporate access provided in the onshore market makes its transition from a beta to an alpha story a compelling relative value story, in our view.

The current macro environment provides what we consider a perfect backdrop for hedge fund investors: a shifting macro picture along with ongoing structural alpha opportunities and a relative dearth of capital in relation to the opportunity set.

⁹ National Bureau of Statistics, Feb. 2021. www.globaltimes.cn/page/202102/1216746.shtml

The value of a green transition

Seeking **greener alternatives**



Bruno Bertocci
Head of the Global Sustainable Equities team, Lead Portfolio Manager of the Global Sustainable Equity Portfolio and the Global Sustainable Impact Equity Portfolio



Adam Gustafsson
Qualitative Researcher, Quantitative Evidence & Data Science (QED) team

We believe embedding a proprietary valuation framework in the green transition is the next natural step in the evolution of 'E' in ESG. This provides a way for investors to support the corporate green transitions that need to happen now.

Investors have begun questioning 'green investing' strategies that merely employ tilts and exclusions to reduce high-emission companies in their portfolios.

We believe the new frontier of climate investing is helping support the heavy emitters that are making key changes to their businesses to significantly improve their carbon footprint.

Time to take action

The 'E' in ESG (environmental, social and governance) has come a long way; conveying the urgency of our climate crisis is no longer where the battle stands.

Governments, companies and investors are all pushing forward with green plans, but we believe the most important global emissions metrics are still moving in the wrong direction.

Is it too early to expect results or are our common efforts ineffective? The effectiveness of investors' portfolio tilts and exclusions is increasingly being questioned, and for valid reasons. Therefore, the frontier of climate investing is shifting beyond superficially 'greening' portfolios to greening the assets in them. Investors can and should support polluting companies in their green efforts and thereby play an active role in solving the climate crisis. Furthermore, we believe this is a great commercial opportunity, aligned with the fiduciary duty of asset managers to deliver returns and manage risk.

This paper provides an overview of a proprietary valuation framework embedding the impact of a green transition. It serves as a technical foundation for UBS's efforts in supporting the corporate green transitions that need to happen now. We believe it is the next natural step in the evolution of 'E' in ESG.



Cap-and-trade empowering a greener future

The EU emissions trading system (EU ETS) is a cornerstone of the EU's policy to combat climate change. It is the world's first major carbon market and remains the biggest one, though carbon markets are being introduced in other countries. In April, EU ETS reached a record high above USD 60,¹⁰ and is expected to go higher. Predicting the future EU ETS price is not part of the framework.

Instead, the model works with a range of future EU ETS price scenarios to forecast the cost of emissions. In Europe, many of the most polluting sectors are protected and handed free allowances. Even if they don't pay the full price of emissions, there are still meaningful valuation implications.

Linking sustainability and business performance

Abatement efforts can be made to offset the, in some cases, escalating cost. These efforts are modelled systematically with Marginal Abatement Cost Curves (MACCs). The MACC is a clever translation mechanism between corporate investments in abatement levers and emission reductions.

They are sector-specific and all investments come with associated CAPEX, OPEX and technical life – everything needed to bring them into our discounted cash flow (DCF) valuation framework.

This part of the framework has been developed in collaboration with Material Economics, a leading management consultancy on the link between sustainability and business performance.

All-in, despite its simplicity, the framework captures the valuation dynamics well. Showing that green transitions drive financial value is essential for us to justify these investments and to support companies in their climate efforts. The framework forms a foundation for company-specific climate engagements, to identify gaps where announced targets are not aggressive enough and in those cases encourage companies to go further.

¹⁰ "Carbon Hits Record 50 Euros on Tighter Pollution Rules." Bloomberg, May 4, 2021. www.bloomberg.com/news/articles/2021-05-04/carbon-permits-hit-record-50-euros-on-tighter-pollution-rules

Green transitions drive financial value

Companies' environmental externalities have always had a cost to society. An EU ETS allows for the emissions part to be expressed in monetary value, which in turn should be reflected in corporate valuations. Financial analysts go to great lengths in forecasting other value-drivers, but rarely account for emissions.

We believe this leaves risks and rewards vastly mispriced. Even worse, when investors don't recognize the value of a green transition, it may indirectly hold companies back from taking the steps so desperately needed for the climate. Modelling the value of a green transition is challenging and associated with numerous assumptions. But since when has that stopped us from trying?

The DCF model has been around for hundreds of years and still rules the world of active investing. By adding three extra line items, the valuation impact of a green transition or lack thereof can be captured.

The three lines are: emission cost, green OPEX and green CAPEX. The cost of emissions which can be expressed as:

$$\text{Emission Cost} = (\text{GHG Emissions} - \text{Free Allowances}) \cdot \text{Price of EU ETS-Passthrough}$$

When a company has free allowances to spare, the emission cost turns negative, i.e., they sell emission permits and make a profit. If a company cannot cover their emissions with free allowances, they have to buy additional emission permits at the market price.

Part of the cost may be passed on to customers depending on competitive dynamics in the specific industry. How much is likely to vary over time and also to be dependent on achieved abatements.

Green OPEX and CAPEX are treated as incremental to business as usual (BAU) and simply layered on top of baseline numbers.

Green transitions in heavy industry

For heavy industry (aluminium, cement, chemicals and steel) the meaningful emissions are linked to actual production. Smelting processes and kilns are energy demanding and still predominately fuelled with coal. The products are commoditised but essential to society.

Without any commercial substitutes in sight, an end to our cement or steel dependence is today unthinkable. Steel is essentially infinitely recyclable, an important circular lever in developed countries with scrap metal but we still need to add new steel in developing countries.

Emissions from heavy industry are material and referred to as 'hard-to-abate,' a toxic combination. In Europe, the full EU ETS price would force many of these companies out of business, or to relocate to other regions. Production in other regions is by no means greener and therefore most of these sectors are on the EU's carbon leakage list, i.e., they get free allowances.

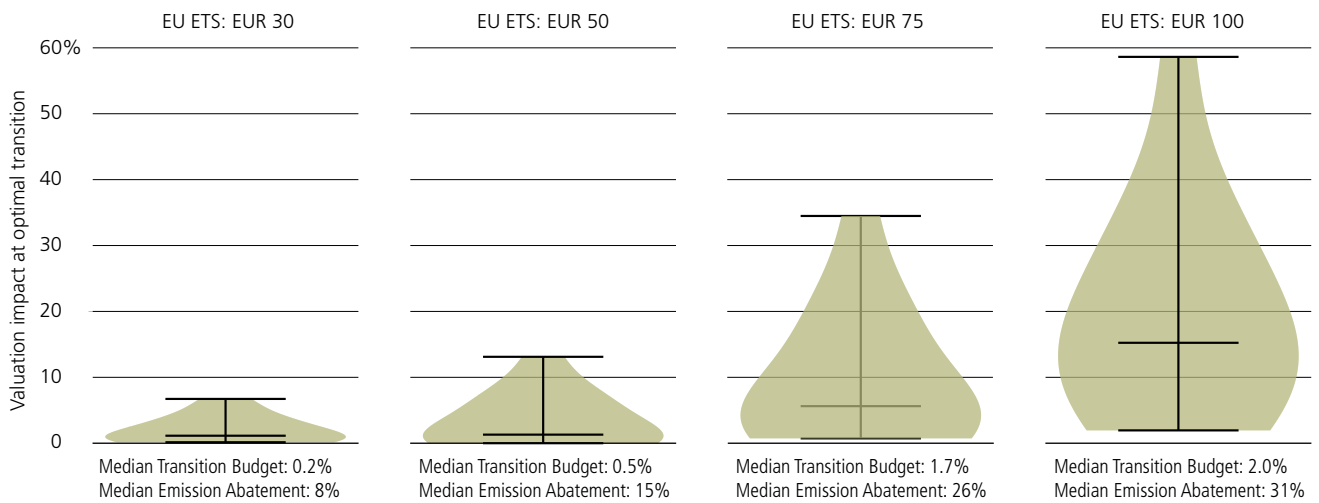
Pushing forward with aggressive green transformation programs is in the interest of companies, investors and the climate.

Luckily, it turns out that substantial abatements are not only possible, but value accretive. We believe this is one of the most misunderstood opportunities in today's markets, both from an investor and climate point of view.

In our view, the MACCs suggest abatement potential of around 30% by 2030 for most of these sectors. When abatements are achieved, free allowances no longer needed can be sold and turned into profits. This is how the EU ETS is intended to incentivize

abatements. Not realizing these abatements is economically suboptimal and leaves companies exposed to unnecessary risks. We believe that pushing forward with aggressive green transformation programs is in the interest of companies, investors and the climate.

Valuations and abatements grow as the EU ETS price rises



Source: UBS QED as at 21 June 20221.

This chart is based on 14 European cement and steel companies. The 'violins', Barbapapa-lookalike charts are showing how valuation impacts are distributed under different EU ETS price expectations for 2030. We have combined steel and cement companies: they are in many ways similar but cement tends to have a higher impact. If we assume the EU ETS will reach EUR 75 by 2030, the median company should invest 1.7% of annual revenue in green transition levers allowing them to abate 26%.

Why UBS Asset Management

Drawing on the breadth and depth of our capabilities and our global reach, we turn challenges into opportunities. Together with you, we find the solution that you need. At UBS Asset Management we take a connected approach.



Ideas and investment excellence

Our teams have distinct viewpoints and philosophies but they all share one goal – to provide you with access to the best ideas and superior investment performance.



A holistic perspective

The depth of our expertise and breadth of our capabilities allow us to have more insightful conversations and an active debate, all to help you make informed decisions.



Across markets

Our geographic reach means we can connect the parts of the investment world most relevant for you. That's what makes us different – we are on the ground locally with you and truly global.



Solutions-based thinking

We focus on finding the answers you need – and this defines the way we think. We draw on the best of our capabilities and insights to deliver a solution that is right for you.

What we offer

Whatever your investment profile or time horizon, we offer a comprehensive range of active and passive investment styles and strategies designed to meet your needs across all major traditional and alternative asset classes. We also offer platform solutions and advisory support, to institutions, wholesale intermediaries and wealth management clients. We are a truly global firm with principal offices in Chicago, Frankfurt, Hartford, Hong Kong, London, New York, Shanghai, Singapore, Sydney, Tokyo and Zurich. Our invested assets total USD 1.1 trillion¹¹ and we have around 3,400¹² employees, including around 880 investment professionals, located in 23 markets.

Who we are

We are one of the largest managers in Alternatives: the second largest fund of hedge funds manager¹³ and amongst the top 10 largest managers globally of direct real estate.¹⁴ We are a leading fund house in Europe, the largest mutual fund manager in Switzerland¹⁵ and ranked the second foreign firm in China.¹⁶ UBS's unique passive offering, encompassing index and systematic strategies, provides smart beta, alternative indices, and other custom solutions to meet our clients' needs. We are the second largest European-based indexed player¹⁷ and the leading sustainability ETF provider in Europe.¹⁸

Past performance is not indicative of future results.

¹¹ As of 31 March 2021.

¹² As of 31 December 2020 (updated annually). Around 1,150 internal and external FTE from Group Functions (representation functions within the Group Functions spending 80% or more of their time on UBS-AM – serving as a conservative proxy for Group Functions).

¹³ HFM InvestHedge Billion Dollar Club, published October 2020.

¹⁴ IPE Real Estate Institutional Investment Manager Survey 2020, data as of 30 June 2020.

¹⁵ Morningstar/Swiss Fund Data FundFlows, March 2021.

¹⁶ Broadridge, April 2021.

¹⁷ UBS Asset Management analysis of AUM from company disclosures, June 2020.

¹⁸ Market share in Europe for sustainable ETFs: 18.9%, Source Etfbook as of 20 April 2021.

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Americas

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EMEA

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