

ElectionWatch

Perspectives on the 2016 US elections from UBS CIO Wealth Management Research

14 June 2016



Tragedy in Orlando

One more piece in a complex political puzzle

Until this past weekend, when a gunman entered a Florida nightclub to murder more than four dozen innocent people, the city of Orlando was better known for dramatic population growth and unparalleled job creation. Tourists flocked to the region for family holidays. Immigrants arrived to participate in the growing economy. Henceforth, that reputation may be tarnished by Sunday morning's horrific events. The immediate emotional anguish for the victims' friends and family members will resonate among all Americans apprehensive over the random violence affecting so many cities across the country.

The perpetrator in this past weekend's shooting does not appear to have any organizational ties to international terror groups, but he did swear allegiance to ISIS before beginning his rampage. We do not expect a lone wolf attack to have a decisive impact on the election, but it has already shifted the focus of each candidate's rhetoric. Secretary Clinton condemned the assault as an act of terror and a hate crime. She reiterated her support for restrictions on the possession of firearms and pledged to "redouble our efforts to defend the US from threats at home and abroad."

Mr. Trump, for his part, seized the opportunity to criticize the Obama Administration over its immigration policy and repeated his call for a temporary ban on Muslim immigration. His decision to launch a bellicose attack on his political opponents in the wake of the Orlando shooting was another example, if one were needed, of his willingness to abandon conventional campaign norms in his quest for the presidency. As we have discussed in prior editions of *ElectionWatch*, economic growth and national security constitute the two most

important public policy priorities for most American voters. This weekend's tragedy has increased the likelihood that terrorism will be at the top of the agenda at each of the candidates' campaign events for weeks to come.

In other news, Senator Sanders appears poised to concede the Democratic nomination to Secretary Clinton after the polls close in the District of Columbia today. Clinton's victories in New Jersey and California undermined Sanders's contention that he was better suited to a general election campaign against Donald Trump.

Our focus this month

In this month's edition of *ElectionWatch*, we examine each candidate's policy prescriptions for the energy and technology sectors of the US economy. We also examine the prospect of a third-party candidate joining Clinton and Trump on stage for the presidential debate this autumn. The American electoral system poses formidable obstacles to independents and third-party candidates, but, on occasion, they can influence the outcome by drawing votes away from one establishment candidate or another. We conclude this month's edition with a rationale as to why this election season has been defined by the disaffected voter.

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Politics won't trump fundamentals

By **Kevin Dennean, CFA**, Technology Sector Strategist



As the two presumptive presidential candidates prepare for a bruising general election campaign, voters are likely to receive more information regarding the nominees' policy platforms. The US information technology (IT) and telecommunications sectors thus far have not received the same level of scrutiny as the pharmaceutical sector. Even so, tax policy and the potential for regulatory changes consti-



Kevin Dennean discusses this article in a [short video](#). Click the photo to watch.

tute important investment considerations. We believe that momentum in Congress to address the repatriation of corporate cash is building. We also expect that changes at the Federal Communications Commission (FCC) will fail to overcome the regulators' disdain for further industry consolidation.

Repatriation tax holiday

US corporations have an estimated USD 1.5tn in overseas cash as a result of profits generated in markets where the statutory tax rates are below the US tax rate.¹ Companies that return these profits to the United States are subject to a so-called repatriation tax, which is the difference between the rates at which the United States and other countries tax corporate profits. Many corporations have chosen to leave earnings in overseas subsidiaries for future investment in operations beyond the reach of Uncle Sam rather than incur the additional tax liability. The "trapped cash" cannot be used for

domestic reinvestment, dividends, share buy-backs, or acquisitions of other US companies.

The IT sector derives approximately 60% of its aggregate revenue from international markets, the highest of any sector in the S&P 500 index. The profitability of international operations is also enhanced in many instances by the allocation of administrative costs and the expenses associated with research and development to the US business. This has led to a significant accumulation of corporate cash in overseas enterprises. Six of the ten companies with the largest gross cash balances in the S&P 500 IT sector had, on average, more than 90% of their cash balances held overseas (see Fig. 1). Together, these companies held more than USD 500bn in cash outside the United States.

Cash repatriation likely to have limited impact

The remaining candidates have either explicitly expressed their support for legislation to promote the repatriation of cash or have backed repatriation in the past. For example, Mr. Trump has proposed a tax on repatriated profits at a

Fig. 1: US S&P 500 IT sector – 10 largest gross cash positions

In USD bn and %

Company	Total	Offshore	% Offshore
Apple	232.9	208.9	90%
Microsoft	105.6	102.8	97%
Alphabet	75.3	42.9	57%
Cisco	63.5	57.2	90%
Oracle	50.8	46.8	92%
Qualcomm	30.0	27.1	90%
Facebook	20.6	2.2	11%
Intel	15.1	14.0	93%
EMC	15.0	12.1	81%
IBM	14.9	Not disclosed	n/a

Source: Company reports as of December 2015 through March 2016, UBS

Politics won't trump fundamentals

discounted 10% rate and the imposition of a standardized tax regime to end the deferral of taxes on corporate income earned abroad.² Secretary Clinton has not made any definitive comments regarding repatriation, but, it should be noted that as a senator, she voted for legislation that included repatriation. The UBS US Office of Public Policy believes she would be interested in repatriation as part of a package that pays for increased infrastructure spending.

Proponents of incentives for the repatriation of corporate cash argue that IT companies would redeploy the repatriated cash into the development of new products or at least use the funds to repurchase stock. Skeptics are apt to remind members of Congress that the last attempt to stimulate new corporate investment through a tax holiday was unsuccessful.³ For our part, we believe the impact of any cash repatriation is relatively modest. US corporations enjoy relatively easy access to capital at a historically attractive cost of capital. Moreover, the IT sector already repurchases substantial amounts of outstanding stock, often financed by the sale of fixed income securities, regardless of the cash "trapped" overseas.

FCC unlikely to allow further wireless consolidation

For the telecommunication sector and its investor base, the FCC is always in focus. FCC Chairman Tom Wheeler is likely to step down following the presidential election in November. In the time remaining, we believe the chairman's office is trying to accomplish much in areas including net neutrality (currently in the DC Circuit Court of Appeals), wireless auctions, privacy reform, and preferred access for business data, among other issues.

Even so, we believe many investors have refocused their attention on the potential for new leadership at the FCC to be more receptive to consolidation in the US wireless market. This industry is widely viewed as having too many competitors, resulting in higher competition and lower returns. We do not believe the FCC will allow consolidation, regardless of which political

We do not believe the FCC will allow consolidation, regardless of which political party holds the White House or Congress.

party holds the White House or Congress. First and foremost, the FCC operates with a staggered board, so any change in FCC leadership would have a limited immediate impact. More importantly, the FCC has made it clear that they evaluate proposed mergers with the intent to promote competition and improve service delivery to consumers. Indeed, the agency has cited the benefits realized in terms of more attractive pricing and increased network investment after blocking previously proposed mergers.

In our view, the FCC is fairly pleased with the pace of innovation and the level of competition following its denial of the proposed Sprint and T-Mobile USA merger in 2014. First, T-Mobile has become one of the more aggressive and innovative carriers in the US market. The company has continued to invest in its network and offered new services to US consumers. Second, Sprint received a significant equity investment from Softbank in the wake of the rejected merger. This result has served a healthy, competitive balance in the wireless market that has proven beneficial to customers. However, we do believe the FCC may be receptive to acquisitions of US wireless companies by non-telecom companies, such as cable operators.

- We believe that momentum in Congress to address the repatriation of corporate cash is building.
- However, we do not believe repatriation would be a catalyst for IT sector shares.
- We do not believe the FCC will allow consolidation, regardless of which political party holds the White House or Congress.

A partisan divide

By **Nicole Decker**, Energy Sector Strategist



Energy policy is a contentious political subject. In addition to those limited instances when a severe supply shortage leads to a broader consensus regarding the urgent need for more oil and gas, the subject provokes a robust debate over how to balance the merits of conservation and environmental protection with the need to ensure reliable and affordable energy supplies. The campaign rhetoric regarding energy policy has been more superficial than usual, a development we attribute to the current ample supply of fossil fuels. By and large, the two presumptive presidential candidates are light on the details but generally have adopted their respective party's traditional positions on energy: Donald Trump has expressed support for the oil and gas industry; Hillary Clinton has emphasized environmental protection.

We do not anticipate a major upheaval in US energy policy. The president of the United States is influential in directing the conversation on energy policy, but a deep partisan divide has made it difficult to pass major regulatory or policy legislation. Policy uncertainty is counterproductive for the capital-intensive energy industry,



Nicole Decker discusses this article in a short video. Click the photo to watch.

but a public debate will ultimately move policy forward. We expect that both candidates will be pressed for details on their energy views as they pivot to the general election campaign. Some recent issues may be revisited. For instance, Mr. Trump recently proposed lifting the moratorium on oil and gas production on federal lands. He also supports the Keystone XL Pipeline. Secretary Clinton is opposed to both.

Both candidates have expressed support for comprehensive tax reform. However, any substantive revision to the Internal Revenue Code is certain to engender opposition from industries that benefit from the existing tax structure. We do not foresee

A deep partisan divide has made it difficult to pass major regulatory or policy legislation.

the oil and gas sector as either a major winner or loser if comprehensive tax reform is enacted. The benefits provided to taxpayers by master limited partnerships (MLPs) are significant at the individual level, but in aggregate do not constitute enough foregone revenue to represent much of a target for legislators. We believe elimination of the MLP structure is unlikely; however, we could see a modest refinement in the types of businesses that qualify as MLPs.

We anticipate three broad topics to dominate the energy policy debate during the general election campaign, namely infrastructure investments, oil and gas industry regulation, and climate change.

Who pays the bill?

The nation's physical infrastructure is aging, and the invoice for repairs is increasing rapidly. The deteriorating condition of our roads and bridges is widely recognized, but Congress has failed to reach a consensus on how to pay for the repairs from current revenue. The Highway Trust Fund no longer receives sufficient revenue from the federal gas tax as increasingly fuel-efficient vehicles consume less gasoline. The federal tax rate also has not been increased in more than 20 years, so the revenue derived from the tax, when adjusted for inflation, has actually fallen (see Fig. 1 next page). We do not expect the GOP to support an increase in the fuel tax regardless of its characterization as a "user fee." Mr. Trump has expressed support for rebuilding US infrastructure, but has not specified the means by which

A partisan divide

those improvements will be funded. Deficit financing may be his default option.

President Obama's fiscal 2017 budget proposal included a USD 10/bbl surcharge to oil companies for oil produced in the US to help fund a "21st Century Clean Transportation Plan." This would replace our current system, which encourages reliance on traditional hydrocarbons. This proposal is not likely to pass, but it does offer a glimpse at the likely Democratic policy platform.

Oil and gas regulation: Is "fracking" at risk?

Mr. Trump recently endorsed fracking and vowed to "revoke policies that impose unwarranted restrictions on new drilling technologies." Hillary Clinton has criticized fracking, but stopped short of a permanent ban. She cited several conditions under which more regulation on fracking would be required and has voiced concerns about methane releases, water pollution, and energy companies' failure to disclose the chemicals they are using. We believe the window for a federal ban on fracking has passed. Shale resources now account for 48% and 62% of US oil and natural gas production, respectively (see Fig. 2). Banning fracking could be disruptive to oil and gas supplies, causing a potential sharp tightening in the global markets and subsequent price spikes.

Climate change: Rhetoric mirrors Americans' conflicted views

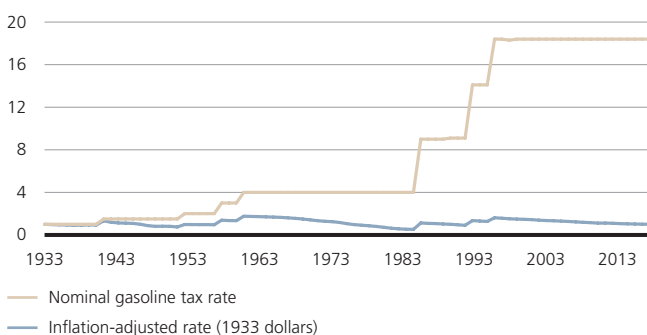
Americans rarely speak with one voice on the subject of climate change. Secretary Clinton has called climate change an "urgent threat" to our

country. She favors a transition away from fossil fuels to "make America the clean energy superpower of the 21st century." In this vein, Secretary Clinton would remove "subsidies" for big oil, plowing savings into alternatives. Mr. Trump, initially dismissive of climate change issues, has softened his position. He did say he would renegotiate the Paris Climate Treaty, but he also endorsed the development of renewables and alternatives, and he has delivered mixed messages regarding federal subsidies.

- We anticipate the 2016 presidential candidates to be pressed for more detail on their views on infrastructure, regulation, and climate change.
- Regardless of who wins in November, we do not anticipate significant changes in energy policy, given the partisan divisions in Congress.
- We project ongoing development in US energy, both in hydrocarbon-based fuels, as well as in alternatives. We see a federal fracking ban as improbable.
- For investors in the oil and gas industry, we see opportunities in onshore US oil and gas operators for the near term, particularly as energy commodity prices recover. Please refer to our energy Equity Preferences dated 9 June 2016.

Fig. 1: Nominal gasoline tax rates vs. inflation-adjusted rate through 2015

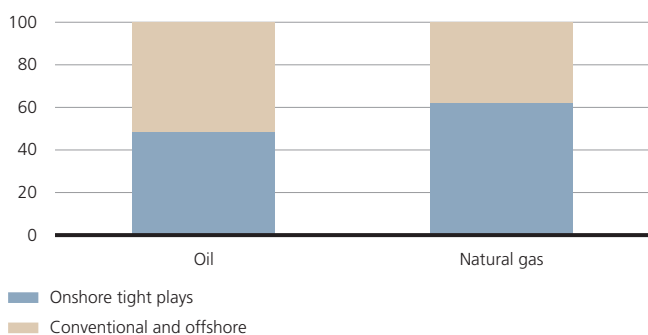
Gasoline tax rates in USD cents per gallon



Source: Congressional Research Service, Tax Foundation, Bureau of Labor Statistics, UBS, as of 9 June 2016

Fig. 2: Tight oil and gas represents a significant portion of US oil and gas production


US oil and gas produced with new extraction techniques, in %



Source: Energy Information Administration, UBS, as of May 2016

Three's a crowd

By **Brian Nick**, Head of Tactical Asset Allocation US, and **Tom McLoughlin**, Co-head of Fundamental Research

 With the presumptive presidential nominees for both major political parties sitting decidedly underwater in their approval ratings with voters, this election year is being hailed by many as the most fertile for a third-party candidate since at least 1992. In that election, businessman Ross Perot garnered nearly 19% of the popular vote and was actually the second-place finisher in Maine and Utah. Although he failed to win any electoral votes, his was the most consequential third-party candidacy since former President Teddy Roosevelt ran on the Progressive Party (aka "Bull Moose") ticket in 1912 against incumbent President William Howard Taft and Woodrow Wilson in 1912. Roosevelt and Taft split the Republican vote, delivering the White House to Wilson.

Almost a century later, Green Party candidate Ralph Nader managed only 2.7% of the vote against George W. Bush and Al Gore. But the 97,488 votes he received in the pivotal state of Florida dwarfed the improbably slim 537-vote margin that eventually delivered the state and the presidency to Bush. For this reason, Nader's presence in the race is widely viewed to have cost Al Gore the White House.

This year, prominent politicians like former New York City Mayor Michael Bloomberg and 2012 Republican presidential nominee Mitt Romney have openly flirted or been urged to run as independent candidates. Both have demurred. The process for a truly independent insurgent candidate to ensure that his or her name appears on all 50 state ballots is costly and time-consuming, which is one reason that few have attempted it. Instead, we are more likely to see candidates from established political parties, such as the Libertarian Party or Green Party, make some noise in this election. Those parties already have a slot on most or all state ballots, although as Fig. 1 shows, neither has managed to capture a significant percentage of voters in recent contests.

But might that change in 2016? The Libertarian Party ticket is headlined by two former Republican governors, Gary Johnson and Bill Weld. It is possible that voters who normally vote Republican but are reluctant to back Donald Trump could give the Libertarian Party a look. At the same time, disenchanted left-leaning voters who backed Senator Bernie Sanders in the Democratic primary against Hillary Clinton could be attracted to Libertarian policies on drug decriminalization and a less militaristic foreign policy. The current RealClearPolitics average of polls, which includes Gary Johnson, shows him at 9%, while the gap between Clinton and Trump is only 2.5%. In order to be included in the crucial presidential debates starting in September, Johnson must attain 15% in five mainstream polls by Labor Day. Thus far, he has not reached that level in any poll.

While it's still too early to say what precise role a third or fourth party could play in the 2016 presidential race, it seems clear that the unpopularity of the two major party nominees leaves the door open a little wider than normal for Governor Johnson to affect the outcome of the race.

Fig. 1: Top third-party candidate performance

Independent candidate	Party	Year	Popular vote margin of victory*	Votes %	# of Votes
John B. Anderson	Independent	1980	9.7%	6.60%	5,719,850
David Bergland	Libertarian	1984	18.2%	0.25%	228,111
Ron Paul	Libertarian	1988	7.7%	0.47%	431,750
Ross Perot	Independent	1992	5.6%	18.91%	19,742,267
Ross Perot	Reform	1996	8.5%	8.40%	8,085,402
Ralph Nader	Green	2000	-0.5%	2.74%	2,882,955
Ralph Nader	Independent	2004	2.46%	0.38%	465,151
Ralph Nader	Independent	2008	7.28%	0.56%	739,034
Gary Johnson	Libertarian	2012	3.84%	0.99%	1,275,971

* The popular vote margin of victory is the % amount won by the winning candidate of that election year.

Source: fec.gov, uselectionatlas.org, UBS, as of 6 June 2016

Political mavericks tap into popular discontent

By **Tom McLoughlin**, Co-head of Fundamental Research, and **Brian Nick**, Head of Tactical Asset Allocation US



Voter disaffection with conventional politics has been a recurring theme in this year's presidential election campaign. Donald Trump's emergence as the nonconformist alternative to the GOP establishment, reinforced by his daily Twitter feed, captured the attention of social media. His campaign eschewed prepared scripts, a tactic that led to frequent gaffes but resonated with enough primary voters to defy conventional wisdom, enabling him to win the Republican nomination.

Meanwhile, Hillary Clinton's inexorable march to the Democratic nomination was delayed by a Democratic Socialist whose persistent focus on income inequality galvanized younger voters' anxiety about their own employment prospects. Bernie Sanders will apparently fall short of winning the Democratic nomination in Philadelphia, but he has managed to pull the Democratic Party to the left and is likely to occupy a privileged position at the national convention in July. Messrs. Trump and Sanders, both political mavericks, rarely agree on public policy. And yet both individuals have tapped into a vein of popular discontent.

For a nation that had grown accustomed to a vigorous economic expansion after economic recessions, the current recovery has been comparatively anemic. Economic growth has been weak since the second quarter of 2015, and the job market is now growing at the slowest pace in six years.¹ The US economy generated only 38,000 jobs in May, far fewer than the 164,000 that were expected by labor economists. Unemployment is declining, but the labor force participation rate remains low.

There are reasons to be optimistic, of course. Oil prices have risen gradually, offering hope that higher demand this summer will improve conditions in those states dependent on energy production. So, while lackluster economic growth may have contributed to the unexpected appeal

of these two unorthodox candidates, US growth is still positive and higher than that in many other developed economies. So, if the economy alone doesn't explain the appeal of mavericks like Trump and Sanders, what does? We believe there are other factors that explain the rise of Trump and the strong showing of Sanders.

Rising income inequality, exacerbated by the adoption of new technology, is among the most important. The share of pre-tax income going to the top 1% of American taxpayers has risen from 9% in 1970 to 20% in 2012.² The Congressional Budget Office reports that personal income for the top 1% of US households grew by 275% over a nearly 30-year period from 1979 through 2007. Middle-class household income grew by less than 30% over the same time period.³ The dispersion of accumulated wealth in the country, as contrasted with income, has also increased. According to one recent study at the London School of Economics, the wealthiest 0.1% of American taxpayers retain approximately 22% of the aggregate wealth in the US, a substantial increase from the 7% this cohort controlled in 1979.⁴

Tech displaces labor

The increasing disparity in wealth has many root causes, but one stands out. Automation and other advanced technology applications have displaced many American workers. Individuals lacking a college degree were more likely to land a middle-class job at a relatively high wage a generation ago. Ubiquitous e-mail applications have displaced postal workers and mail clerks. The delivery of books and music through the internet has eviscerated traditional jobs associated with the publishing and music industries. Utilities rely on automation to reduce the need for individuals to "read meters" and perform clerical tasks. The introduction of robotics has reduced the demand for workers on assembly lines and in warehouses. Customer self-service, online and in person, has allowed employers in the restaurant and transportation industries to reduce employment.

Political mavericks tap into popular discontent

The inexorable shift to a service economy has had a profound impact on middle-class incomes. According to a recent study by the Brookings Institution, individuals without a college degree are less likely to hold a full-time job and are more likely to have been displaced from traditional blue-collar work. As they seek other employment, they are likely to earn less. In fact, according to one study, the shift to service jobs can explain up to 40% of the decline in annual earnings for the typical worker without a college degree.⁵

Donald Trump's plea to "make America great again" has an inherent appeal for individuals who have been laid off from jobs that no longer exist and who have been forced to accept lower wages. Many Americans are struggling to adapt to the new service economy where substantial technical expertise is required. Meanwhile, Senator Sanders has appealed to younger Americans who may not yet even be in the workforce, but who are already anxious

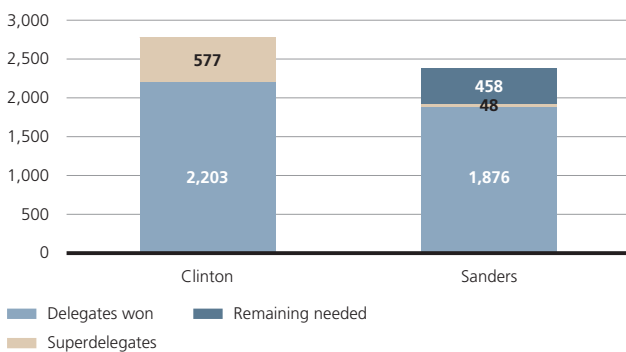
about their economic prospects. His message of greater equality through higher taxation on the wealthiest Americans may resonate among some Millennials saddled with burdensome student loan debt and who are, in many cases, underemployed.

The net effect is an increase in voter disaffection and a profound skepticism of the political process. The speed at which new technology is introduced is unprecedented, and the introduction of autonomous cars and trucks is just around the corner. That development will only exacerbate the dislocation of unskilled labor. Of course, if history is any guide, new types of jobs (many of which are not yet even contemplated) will accompany the displacement of human labor. But in the meantime, some voters may be inclined to blame illegal immigration or free trade for the uncertainty accompanying life in an age of advancing technology.

Candidate delegate count update

Democrat delegate count

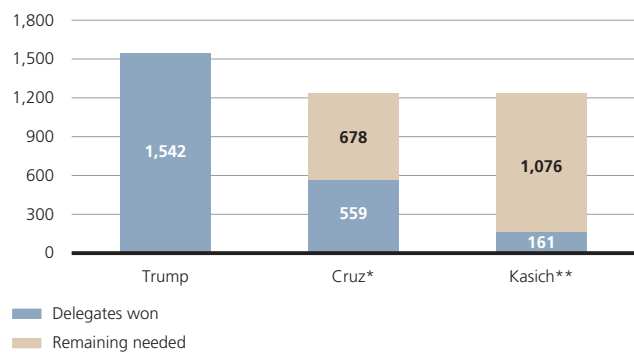
2,382 needed to win on the first ballot



Source: [RealClearPolitics](http://www.realclearpolitics.com/epolls/2016/president/democratic_delegate_count.html)
(http://www.realclearpolitics.com/epolls/2016/president/democratic_delegate_count.html),
UBS, as of 10 June 2016

Republican delegate count

1,237 needed to win on the first ballot



Source: [RealClearPolitics](http://www.realclearpolitics.com/epolls/2016/president/republican_delegate_count.html)
(http://www.realclearpolitics.com/epolls/2016/president/republican_delegate_count.html),
UBS, as of 10 June 2016

* Ted Cruz suspended his GOP President campaign on 3 May 2016

** John Kasich suspended his GOP President campaign on 4 May 2016

Footnotes

IT and telecommunications

- ¹ <http://www.ft.com/cms/s/0/368ef430-1e24-11e6-a7bc-ee846770ec15.html#axzz4B5LCc7XY>.
- ² <https://www.donaldjtrump.com/positions/tax-reform> on 31 May 2016.
- ³ Repatriating Offshore Funds: 2004 Windfall for Select Multinationals; Majority Staff Report of the US Senate Permanent Subcommittee on Investigations, October 2011.

Political mavericks

- ¹ UBS House View Weekly, 9 June 2016.
- ² Elizabeth Jacobs, "What Do Trends in Economic Inequality Imply for Innovation," The Kaufmann Foundation, 5 June 2016. The author cites recent research by Emmanuel Saez at the University of California, Berkeley.
- ³ Ibid. The CBO study used the 21st through 80th percentiles when it concluded that incomes had risen by less than 30%.
- ⁴ Ibid. The author cites recent research by Gabriel Zucman at the London School of Economics. See also Kevin Lansing and Agnieszka Markiewicz, "Top Incomes, Rising Inequality, and Welfare," Federal Reserve Bank of San Francisco, May 2016.
- ⁵ Melissa S. Kearney, Brad Hershbein, and Elisa Jacome, "Profiles of Change: Employment, Earnings, and Occupations from 1990-2013," 20 April 2015.

Publication details

Publisher

UBS Financial Services Inc.
Wealth Management Research
1285 Avenue of the Americas, 20th Floor
New York, NY 10019

This report was published on 14 June 2016.

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Acknowledgment

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