

Macro Monthly

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For marketing purposes.

UBS Asset Management | **Economic insights and asset class attractiveness**
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The case for commodities

Highlights

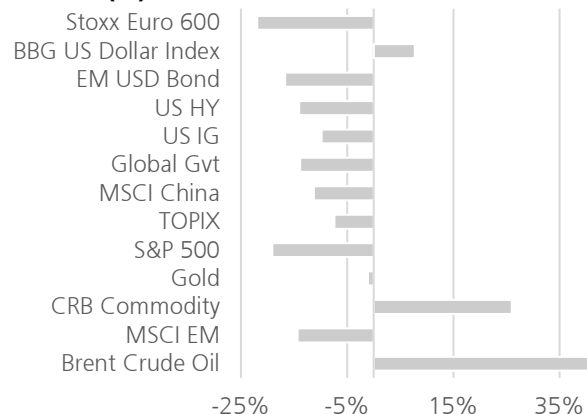
- Commodities and commodity-linked equities were among the few standout performers in the first half as inflation disrupted most asset classes.
- Positioning in these assets has been curbed recently due to growing fears of a recession.
- However, commodity-linked assets remain attractive, as these exposures are inexpensive and we believe sentiment has deteriorated much more than fundamentals.
- In our view, global economic activity is decelerating but not yet contracting, and supply growth in commodities is likely to remain constrained in the near term.
- Importantly, Chinese growth is picking up as developed-market activity moderates.

The first half of 2022 demonstrated that commodities and commodity-linked equities are crucial for building resilient portfolios that can thrive in a high inflation environment (Exhibit 1).

However, these assets are also highly volatile and have suffered a substantial drawdown in recent weeks. We believe these market moves have been exacerbated by a large fall in speculative positioning amid increased concern about a future recession.

Now that speculative positioning has been curbed, the current fundamental drivers of the market can reassert themselves. Commodity markets are generally much less forward-looking than stocks and longer-term bonds, since they reflect current supply/demand conditions. As such, these exposures may perform well in a late-cycle environment where demand is slowing, but positive – so long as supply remains limited. That is the backdrop we expect will prevail over the near term, particularly for energy-linked assets. We believe pullbacks are likely to be buying opportunities so long as the onset of a recession is not imminent.

Exhibit 1: Standout performance from commodities in 1H 2022 (%)



Source: UBS-AM, Bloomberg, data as at 30 June 2022

And in the medium term, commodity demand – particularly copper – is likely to need to rise for countries to both secure energy independence and to decarbonize the energy system. The potential magnitude of this required public and private investment, in our view, puts a higher floor under commodity prices that may somewhat offset the traditional cyclical risks.

Commodity demand may get boost from China

In our view, global economic activity is decelerating, but not to the point of an outright contraction in demand that shifts commodity markets from deficits to surpluses on a sustained basis.

Importantly, China is unlike nearly all major regions in that activity is poised to improve. Beijing’s willingness to deliver measured but meaningful stimulus is not in question, in our view. Better public health outcomes will allow for evidence of this support to appear in the data. China is the dominant driver of demand for many commodities, so this positive inflection may meaningfully offset the slowing in developed-market demand growth.

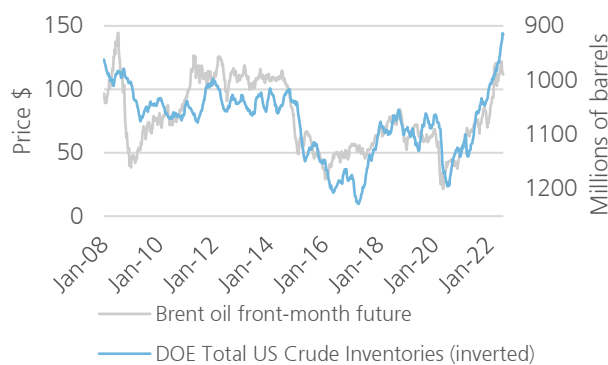
Outside of China, the policy outlook is mixed at present. On the one hand central banks have signaled or embarked upon aggressive rate hiking campaigns to cool activity and inflation. But on the other hand, fiscal authorities are largely opting for subsidies that allow for energy demand to be sustained, rather than energy-conservation measures.

Supply side likely to stay subdued

Resilient demand coupled with a starting position of low inventories (Exhibit 2) in crude and refined products is a recipe for higher oil prices in the absence of supply growth.

US shale companies do not want to expand aggressively, prioritizing profitability over production growth to make up for last cycle’s excessive investment and prolonged period of poor returns for shareholders. Even if they did, any expansion plans would also be constrained by shortages of required inputs such as steel pipes and frac sand. The US is releasing barrels from the Strategic Petroleum Reserve to help mitigate shortages now, but this flow is slated to stop in the fourth quarter.

Exhibit 2: Low inventories imply high oil prices

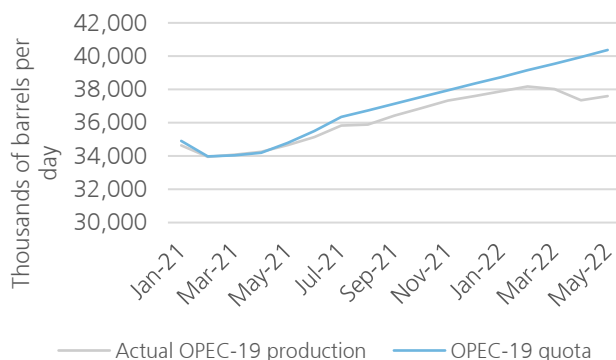


Source: UBS-AM, Bloomberg NEF as at 1 July 2022.

In the event of a ceasefire between Russia and Ukraine, we would not expect the petrostate’s access to global energy markets to improve. Russian production has surprised to the upside relative to initial post-invasion estimates, but sanctions not yet in effect may place more downward pressure on output going forward.

In theory, OPEC+ members like Saudi Arabia and the United Arab Emirates have ample spare capacity, but have seldom been able to produce at higher than current levels for a sustained period of time. It is important to note that this collective has consistently under-produced relative to its quota (Exhibit 3). As such, upside risks to Saudi Arabian or Iranian production need to be weighed against the downside risks, like the protests and thefts which have plagued Libyan and Nigerian output, respectively.

Exhibit 3: OPEC+ production falling far shy of quota



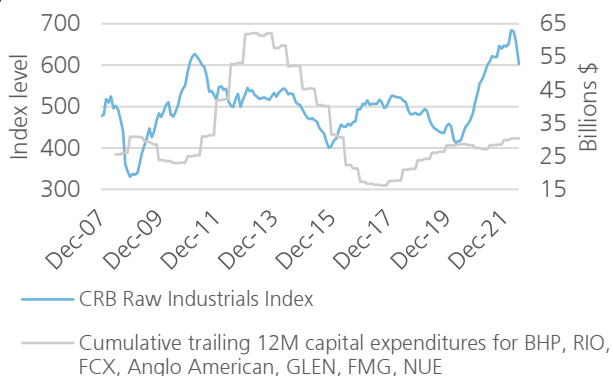
Source: UBS-AM, Bloomberg NEF as at 31 May 2022.

Structural support

The green transition may be to this commodity cycle what Chinese demand was to the 2000s supercycle. And securing energy independence has become a more urgent concern for governments after Russia’s invasion of Ukraine exposed the flaws of relying on non-allied nations for basic necessities.

Barring a massive technological breakthrough, the green transition will be much harder, if not impossible, without strong supplies of copper, because of its superb conductivity. The long lead times for new mining projects to come online make it difficult to remedy supply/demand imbalances under tactical investment horizons. An overview of capital expenditures made by major producers of industrial metals suggests a major supply response is by no means in full swing (Exhibit 4).

Exhibit 4: Supply response in metals subdued versus last cycle



Source: UBS-AM, Bloomberg as at 8 July 2022.

Risks to the thesis

A more severe and sudden degradation of economic activity is the overarching risk to our optimistic call on commodities. The recent drop-off in US gasoline demand is a negative development that we will monitor closely, but do not expect will persist. Gasoline prices have fallen since this time, and nominal income growth is still running well above pre-pandemic norms.

Also, the pandemic is not fully behind us; a COVID-19 mutation that is both more contagious and virulent could reduce mobility and demand. This is particularly the case in China, where policymakers are more sensitive to outbreaks and higher-frequency indicators of mobility have reversed some of their recent gains. Saudi Arabia or Iran could also provide a positive supply shock in oil to help alleviate market imbalances, though we do not think this is likely.

A hard landing in the Chinese real estate sector – a tail risk, not our base case – would be quite negative for industrial metals. And certain developments would be good for some commodities and bad for others. For instance, if Europe were to ration natural gas supplies, this would likely be positive for energy-linked exposures (in part by spurring some gas-to-oil switching, where possible) but negative for metals via lower industrial production.

Over the medium term, a prolonged period of strong capital expenditures that boosted supply would undermine our bullish case. Government policies that sought to ensure more consistent availability of strategically important materials and energy would also likely reduce some near-term commodity upside when enacted, while raising longer-dated commodity futures. The disinflationary forces of technology and innovation could also play a role in reducing medium-term demand for commodities in ways that are not obvious, or even imaginable, at present.

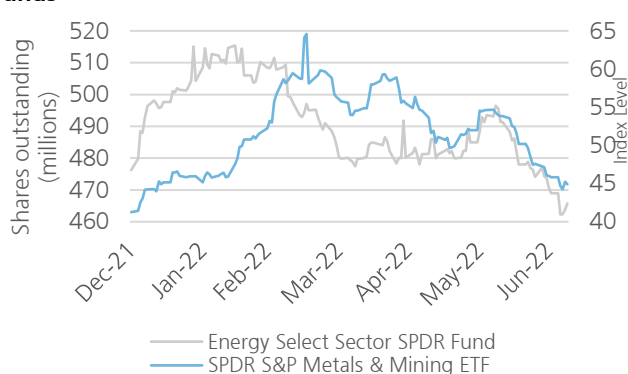
Conclusion

We believe it still makes sense to be overweight commodities and associated equities despite the widespread concern over the growth outlook. Sentiment has shifted much more than the underlying fundamentals, with a mass exodus of investors from commodity-linked exchange-traded funds over the past month (Exhibit 5). Additionally, these assets are useful from a portfolio construction standpoint in hedging any additional geopolitically-induced negative supply shocks.

Energy and materials remain sectors that are extremely inexpensive relative to global stocks (Exhibits 6 & 7) despite having enjoyed a long period of significantly superior earnings revisions. While these are by no means recession-proof parts of the market, we believe that the cheapness does help cushion the magnitude of additional downside should threats to the expansion grow more intense.

As investors have been reminded recently, commodities are by no means a one-way ticket. We plan to be prudent in adjusting these exposures based on tactical considerations, as well as within commodity markets based on frictions between when incremental supply comes on line relative to increases in demand. In our view, the medium-term outlook is for supply to be lagging demand across many commodity markets – giving these assets staying power as an investment theme.

Exhibit 5: Slump in interest for commodity-linked equity funds



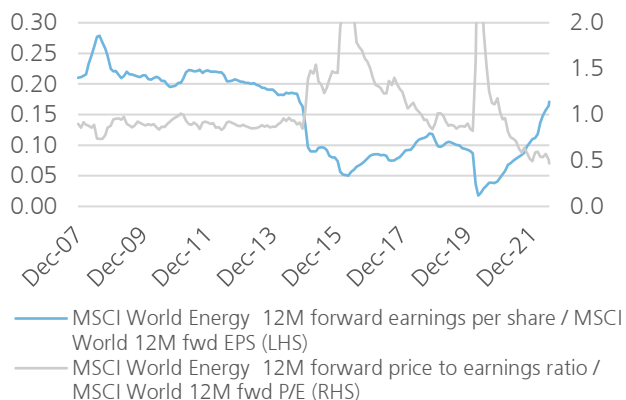
Source: UBS-AM, Bloomberg. Data as of 8 July 2022.

Exhibit 6: Attractive valuations in materials relative to global stocks



Source: UBS-AM, MSCI, Bloomberg. Data as of 8 July 2022.

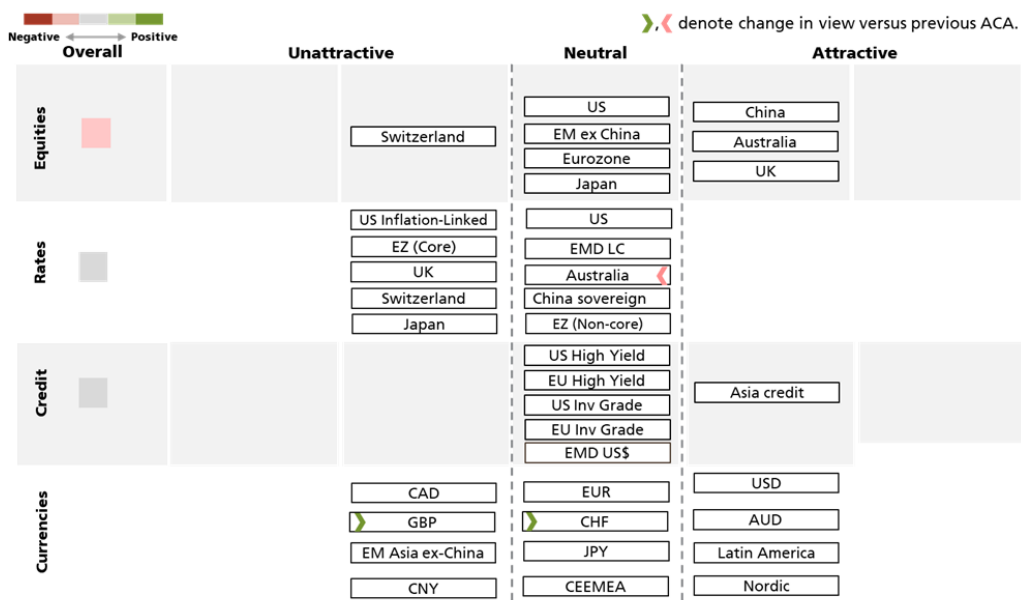
Exhibit 7: Energy stocks very cheap with favorable earnings trends



Source: UBS-AM, Bloomberg. Data as of 8 July 2022

Asset class attractiveness (ACA)

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 7 July 2022. The colored squares on the left provide our overall signal for global equities, rates, and credit. The rest of the ratings pertain to the relative attractiveness of certain regions within the asset classes of equities, rates, credit and currencies. Because the ACA does not include all asset classes, the net overall signal may be somewhat negative or positive.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 7 July 2022. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.



Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
Global Equities	■	<ul style="list-style-type: none"> – In our view, global equities are tactically unattractive at the index level. The equity risk premium implies stocks are still expensive. Equities are likely to face valuation pressures from central bank tightening, while slowing growth also raises downside risks to earnings estimates. – Our view is that market pricing of recession risk is likely to increase because of tightening financial conditions, aggressive rate hikes, a moderation in goods spending, and elevated inflation. However, private sector balance sheets remain strong, spending is rotating rather than shrinking, and core inflationary pressures are likely to cool. A soft landing for the economy remains possible, but it is too soon to trade that view. – As such, we are staying cautiously positioned within equities and prefer sectors like health care and regions such as the UK, which has a more defensive composition. We also are selectively long cyclical via commodity-linked stocks.
US Equities	■	<ul style="list-style-type: none"> – US equities have become more attractive on a relative basis given our cautious view on global equities. – American stocks are more acyclical and tend to outperform when manufacturing purchasing managers' indexes are declining. – Within US equities, we continue to prefer US equal weight to market cap indexes. – US growth is likely to hold up better than other major developed markets. – However, US equities continue to command premium valuations, which may drag relative performance in the event that expectations for the Federal Reserve's terminal policy rate this cycle increase further or geopolitical risks recede.
Ex-US Developed market Equities	■	<ul style="list-style-type: none"> – Non-US developed market equities are attractively valued but also highly cyclical, and tend to underperform in an environment in which manufacturing purchasing managers' indexes continue to decelerate. – Japanese stocks lack catalysts that would help shrink this valuation gap. – Despite recent economic resilience European equities are still vulnerable as Russia continues to wage war against Ukraine and risks to natural gas access and industrial activity. However, this is already partially priced in.
Emerging Markets (EM) Equities (ex-China)	■	<ul style="list-style-type: none"> – We prefer EM markets with the strongest linkages to commodities based on our expectation that the stabilization of growth in China will buoy commodity demand. – EM equities have held up well in the face of challenges early in 2022 that include less impressive earnings revisions and higher mobility restrictions relative to DM, rising long-term real rates, and US dollar strength versus DM FX.
China Equities	■	<ul style="list-style-type: none"> – The Chinese policy stance has turned, both on the monetary and fiscal sides. The PBOC has cut rates, the peak in credit tightening has passed, in our view, and officials are stressing urgency in providing fiscal support. – In our view, investors are discounting too much downside risk associated with China's COVID-19 policies and the real estate market, and not ascribing enough odds to an economic rebound that is already underway. – The relative valuation of Chinese internet companies compared to their US peers suggests too much embedded pessimism about their longer-term earnings prospects, and we believe the intensity of the regulatory crackdown is diminishing. – From a seasonality perspective, Chinese equities have tended to outperform ahead of the China Party Congress.
Global Duration	■	<ul style="list-style-type: none"> – We believe the risks to long-term bond yields are well-balanced after traders have priced in aggressive central bank tightening and economic activity decelerates. We expect real rates to rise as inflation peaks and the Federal Reserve tightens policy, but for this to be offset by decreases in inflation expectations. – Sovereign fixed income continues to play a diversifying role in portfolio construction by hedging downside in procyclical positions.



Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
US Bonds	■	<ul style="list-style-type: none"> – US Treasuries remain the world's preeminent 'safe haven' and top source of risk-free yield. The Federal Reserve is poised to take rates to restrictive territory in order to quell inflationary pressures, even if this damages the labor market and puts the expansion in jeopardy. Quantitative tightening is not a very potent catalyst for fixed income, in our view. – Market pricing for the Federal Reserve's terminal rate this cycle has adjusted meaningfully to the upside, and parts of the yield curve already imply interest rate cuts in 2023. The Fed has set a high bar for inflation to surprise to the upside this year, leaving room for rates to come down across the curve by pricing out some of the expected hikes. Even more front-loaded tightening could also increase perceived recession risk and provide a bid for the long end.
Ex-US Developed-market Bonds	■	<ul style="list-style-type: none"> – We continue to see developed-market sovereign yields outside the U.S. as unattractive. The European Central Bank has outlined a plan to exit negative policy rates by the end of the third quarter, and tactics that aim to compress core and periphery spreads are being considered to increase the scope for tightening without increasing fragmentation risk. – The Bank of Japan's domination of the market and strategy of yield curve control diminishes the use of much of the asset class outside of relative value positions. Maturities beyond the 10-year point may be more vulnerable should the global repricing of duration resume.
US Investment Grade (IG) Corporate Debt	■	<ul style="list-style-type: none"> – US IG all-in yields have become much more attractive given the year-to-date rise in risk-free rates as well as widening spreads. – However, the typically negatively convex performance of credit as market pricing of recession rises provides some cause for near-term caution
US High Yield Bonds	■	<ul style="list-style-type: none"> – High yield spreads have widened significantly and embed more concern about the growth outlook than equities. However, spreads are not yet at levels that prevailed at the peak of growth scares in 2011 and early 2016.
Emerging Markets Debt		<ul style="list-style-type: none"> – We have a neutral view on emerging market dollar-denominated bonds due to the balance of carry opportunity and duration risk, which are offset by downside risks to growth.
US dollar	■	
Local currency	■	<ul style="list-style-type: none"> – Asian credit is enticingly valued and poised to perform well in environments in which highly adverse economic outcomes fail to materialize. – A more positive carry backdrop for EM local bonds following rate hikes delivered over the course of 2021 has increased the resilience of this asset class even as aggressive Fed tightening gets priced in.
China Sovereign	■	<ul style="list-style-type: none"> – The attractiveness of Chinese government bonds has diminished somewhat as nominal rate differentials versus the rest of the world have compressed. However, the appeal of Chinese government bonds is bolstered by their defensive characteristics, which are not shared by much of the EM universe, as well as their low beta to global bond indices. We believe the combination of monetary easing and eventual stabilization of domestic activity should prevent any sustained upward pressure on yields during the next 3-12 months.
Currency		<ul style="list-style-type: none"> – The US dollar is well-positioned to remain elevated, if not strengthen further. Real growth differentials versus other developed market economies are likely to remain substantial because the US is better sheltered from the negative supply shock in energy. Elevated geopolitical risks and the prospect of a broad-based growth scare also put a sturdy floor under the dollar. – Some EMFX, like COP and BRL, are poised to outperform cyclical Asian currencies and select G10 commodity exporters given attractive carry.

Source: UBS Asset Management. As of 7 July 2022. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

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Americas

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EMEA

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