Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness

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Picking our spots

Highlights

- We are more optimistic on global economic activity than consensus in 2023.
- The US labor market, and in turn consumption, will remain solid, in our view, with global growth supported by improving conditions abroad, particularly in China.
- A better-than-expected economy is not all good news for all markets. Higher rates for longer means ongoing de-risking in more expensive equity markets, namely the U.S.
- We believe emerging market equities have asymmetric upside to better-than-expected global activity fueled in part by China's reopening, given cheap valuations and depressed earnings expectations.
- In addition, we favor short-term US Investment Grade credit given the substantial income available at relatively low duration risk.

We come into 2023 with an outlook for the global economy that is more optimistic than consensus. The economy will bend, as the lagged effects of substantial monetary tightening filter through into the economy. But the economy will not break, as nominal and real incomes remain resilient. Moreover, 2022's headwinds – Europe embroiled in an energy crisis, and zero–COVID-19 policies weighing on Chinese activity – are shifting to be tailwinds for global growth in the first half of this year.

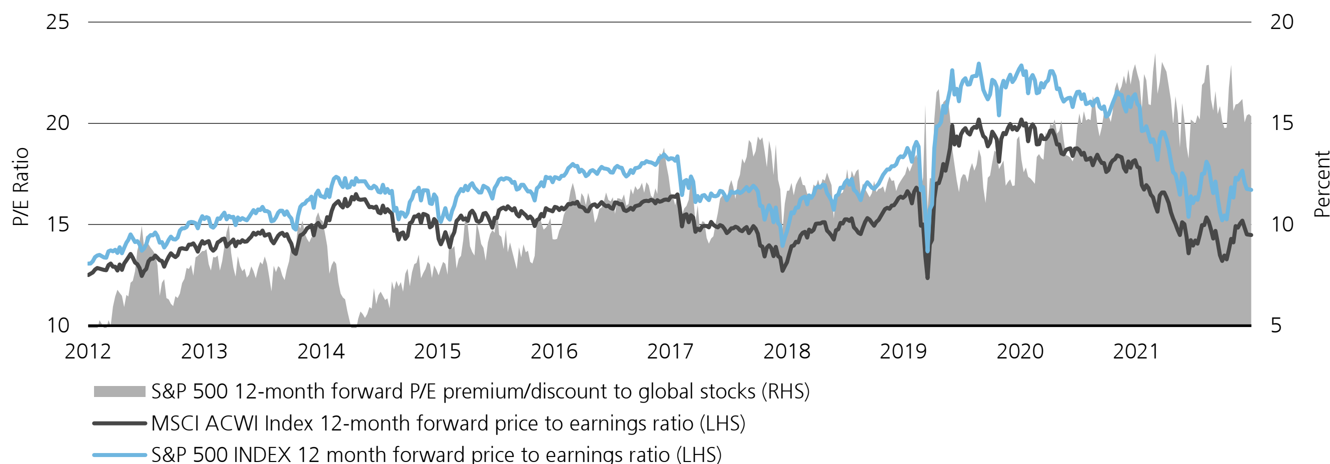
Still, a better-than-expected economy is not all good news for all markets. Resilient labor markets means wages stay elevated, meaning central banks keep rates elevated for some time. Higher rates for longer means ongoing de-risking in more expensive equity markets, namely the growth-biased US market. When it comes to taking risk in 2023, we prefer to pick our spots, allocating capital where cyclicality is more pronounced, like China. In our overall allocation, we prefer high grade credit over equities entering the year, as higher all-in yields have shifted the relative attractiveness for risk assets.

Macro view

The US consumer is the lynchpin of the global economy. Real spending in the US increased at a solid pace in 2022 despite surging inflation thanks to elevated levels of excess savings and strong nominal wage growth. In 2023, the US consumer starts the year with an extra boost in the form of much lower gasoline prices compared to mid-2022.

We do not anticipate a significant deterioration in the US job market – a prerequisite for a retrenchment in real consumption – to happen any time soon. Resilience in the services sector has kept a host of labor market metrics (including payrolls, wage growth and initial jobless claims) at very robust levels even amid some softening in goods sector activity as well as layoffs in the technology sector. Excess savings will be depleted for lower income households, but high-income earners, who are the biggest spenders overall, continue to spend in the services sector. Consumers and businesses have had

Exhibit 1: US stocks quite expensive versus global peers



Source: UBS-AM, Bloomberg. Data as of December 26, 2022.

the opportunity to term out debt at extremely low interest rates, making them less rate sensitive than has historically been the case. Higher social security payments and fiscal transfers from state and local governments should also cushion the economy.

An unfaltering US consumer is putting a floor under the growth outlook that is being reinforced by these global tailwinds of Chinese mobility and improving European energy access – especially the former.

Stocks ≠ economy

There is one key theme from 2022 we expect will carry over into 2023: the stock market is not the economy.
In 2022, the positive impact of strong nominal growth for corporate profits was completely overwhelmed by the most aggressive monetary tightening from the Federal Reserve in more than four decades. Higher rates caused a massive valuation compression.

This trend may be poised to continue in 2023. A more resilient growth environment and still tight labor market means central banks will likely keep rates higher for longer. We believe a continuation of downward pressure on valuations would be primarily a problem for US equities, which comprise about 60% of global equities at the index level and trade at a forward 12-month price-to-earnings ratio approximately 15% above the broad market.

During the pre-pandemic economic cycle, the increasing valuation premium of US stocks relative to their global counterparts could be somewhat justified by their consistent earnings outperformance. However, recent profit revisions have been more negative for US stocks than their global peers. This dynamic leaves US stocks vulnerable to another leg of valuation compression to bring equity multiples closer towards the global average.

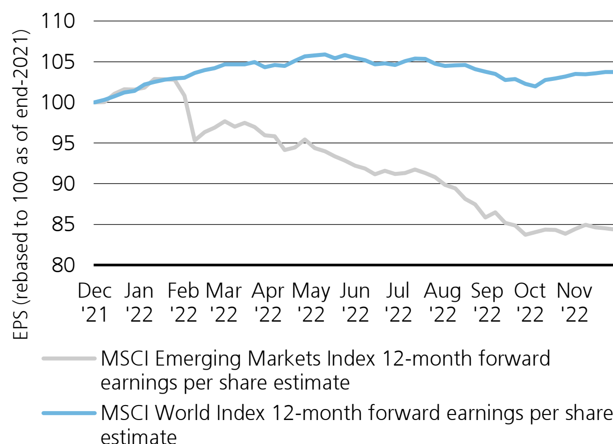
In our view, there are much more attractive ways to benefit from surprisingly resilient activity than equities at the index level. Within equities, we favor emerging markets (EM) over developed markets (DM), and also find short-term US investment grade (IG) credit attractive.

Emerging Markets > Developed Markets

The most meaningful change to the global backdrop over the past three months is China's abandonment of zero–COVID-19 policies. This about-face may cause some acute near-term challenges to activity as public health outcomes deteriorate. But it also means that investors will likely have much more visibility to price in an upcoming rebound in Chinese consumption.

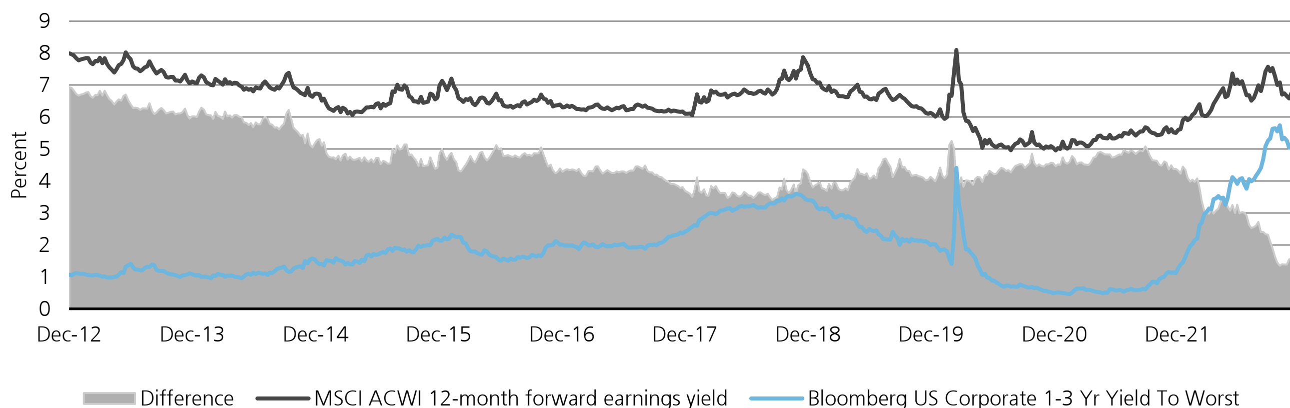
The removal of mobility restrictions and spread of the virus in China are playing out faster than we had anticipated. Already, there are signs that the cities hit the worst and hardest by the recent wave are seeing a pickup in mobility. As a durable reopening takes shape, we anticipate that valuations and earnings expectations for Chinese equities will continue to move higher.

Exhibit 2: Earnings estimates for EM already discounting a lot of profits pain



Source: UBS-AM, Bloomberg. Data as of December 26, 2022.

Exhibit 3: Short-term US investment grade credit attractively valued relative to global stocks



Source: UBS-AM, Bloomberg. Data as of December 26, 2022.

China's elevated weighting in major indexes of emerging market equities drives our view that EM equities will outperform their DM counterparts. Even though China's reopening is primarily a story of recovering domestic consumption, we believe it will still produce positive, but measured, spillovers for its trading partners as well as commodities. Emerging markets have already derated and had meaningful earnings cuts. We believe that means they are less susceptible to additional downside if economic growth disappoints, and have asymmetric upside if cyclical upside is underestimated.

Carrying on

The income available in short-term US investment grade (IG) credit is compelling, in our view, on both an outright basis and relative to Global stocks, and in particular, US stocks.

The spread between the earnings yield on global equities (~7%) and the yield-to-worst for 1-3 year IG US credit (~5.25%) is quite narrow vs recent history. This suggests that investors are getting relatively little extra compensation by moving to a riskier and longer-duration part of the capital structure (from near-term debt to equity).

The corporate credit curve is also very flat due to the inversion of the US Treasury curve, which allows for a similar amount of income to be generated in short-term (vs. longer-term corporate credit) with far less duration risk. Corporate fundamentals, particularly interest coverage ratios, also suggest US companies are in a healthy place and would remain so even if profits moderate somewhat.

Conversely, the range of scenarios for equities are quite wide, with an unfavorable risk-reward profile. Even if activity and earnings hold up well, stocks still have to contend with expensive valuations relative to bonds and discount rates that are unlikely to move much lower in such a backdrop – so upside is relatively capped. Meanwhile, in the event our optimistic view on the economy is wrong, the downside for stocks is likely much more significant than for short-term US Investment Grade credit, outside of any unexpected, extreme negative shock.

Conclusion

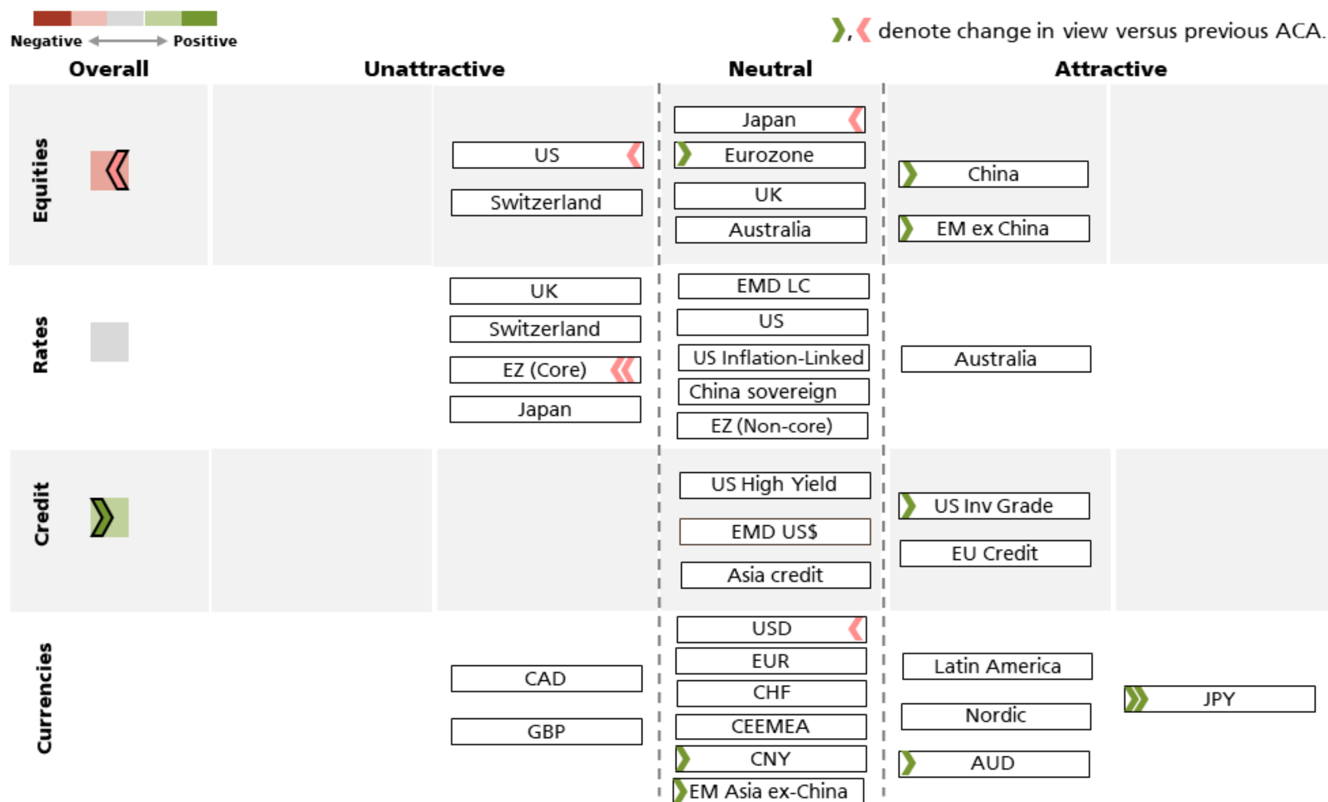
Carry and cyclicality are our preferred exposures for the start of 2023 as the US labor market remains resilient while China reopens and Europe's energy crisis abates.

We believe emerging markets are well-positioned to outperform developed markets if activity exceeds low expectations amid a durable recovery in Chinese consumption. On a sector basis, we also prefer energy and financials.

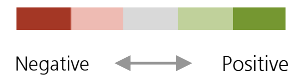
Short-term US IG credit is particularly attractive given high coupons and relatively low near-term domestic recession risk, in our view. Elsewhere, given our view that the US dollar is rangebound, but with a bias lower from here, we also favor positive carry long positions in Mexican peso. Our most preferred currency is the Japanese yen. The recent move from the Bank of Japan to increase how high the 10-year yield can trade is, in our view, a catalyst that will allow a long-inexpensive currency to have an extended, powerful period of mean reversion. The yen also serves as a useful risk-off hedge if growth deteriorates more than we expect.

Asset class attractiveness (ACA)

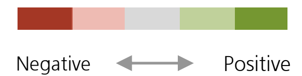
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of January 5, 2023. The colored squares on the left provide our overall signal for global equities, rates, and credit. The rest of the ratings pertain to the relative attractiveness of certain regions 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 January 5, 2023. 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	Light red	– In our view, the risk-reward proposition for global equities is less attractive than for high grade credit. Stocks remain expensive versus bonds based on the equity risk premium, and we believe earnings estimates are biased lower from here. – Importantly, US stocks still account for nearly 60% of global equities, and remain richly valued while also displaying underwhelming earnings revisions. – We are more optimistic on global economic activity than consensus for 2023, but there are better ways to express this view than through equities at the index level. We prefer regions where both monetary and fiscal policy are still highly accommodative, like China, as well as sectors such as financials and energy.
US Equities	Light red	– US stocks have been relatively expensive for a long time, but this valuation premium was justified by superior profit growth. – Recent earnings revisions are more negative for US stocks than for global equities. US stocks are particularly vulnerable to a negative re-rating relative to global equities given this catalyst of earnings outperformance shifting to underperformance. – US equities are also more acyclical and would likely fare poorly versus global equities if activity surprises to the upside, led by a durable Chinese economic reopening.
Ex-US Developed market Equities	Grey	– Non-US developed market equities are attractively valued but also highly cyclical. There is a lot of variation between DM equity markets based on differing domestic policy stances and degrees of vulnerability to external headwinds. – We have high conviction that the yen will appreciate, which diminishes the attractiveness of Japanese stocks in local currency terms. Equities are buoyed by strong domestic fiscal support, which may be reinforced by surprising strength in real activity globally if our optimistic economic view comes to pass. – Success in securing natural gas and a milder start to winter have reduced left-tail outcomes for European equities. However, the ECB is committed to bringing policy rates well into restrictive territory amid a recession, which should limit how much valuations can improve.
Emerging Markets (EM) Equities (ex-China)	Light green	– While China's reopening is primarily a story of recovering domestic consumption, we believe it will still produce positive, but measured, spillovers for its trading partners as well as commodities. – Broadly speaking, EM equities have both re-rated to the downside and have seen larger negative revisions to earnings than DM equities, which limits the scope for relative underperformance versus global equities going forward, in our view.
China Equities	Light green	– The swift abandonment of zero–COVID-19 policies is paving the way for China's economic recovery and the outperformance of domestic risk assets. The removal of mobility restrictions is also being accompanied by more thorough support for the property sector, which bolsters our conviction that economic activity and earnings will improve meaningfully from 2022 to 2023. – In the very near term, activity is likely to remain sluggish because of the rapid growth in COVID-19 cases, but investors will likely be willing to look through this softness, in our view. – We are closely monitoring geopolitical tensions between US and China, as these carry left-tail risks to both operating performance and valuations.
Global Duration	Grey	– Long-term bond yields should be rangebound due to the combination of enduring recession risks, sticky-high inflationary pressures, and US labor market resilience. – Central banks' commitment to tightening – albeit at a slower pace – should drive even more flattening of yield curves.



Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
US Bonds		– 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 a sufficiently restrictive territory in order to quell inflationary pressures, even if this damages the labor market and puts the expansion in jeopardy. In our view, the Fed will continue to slow the pace of tightening, but the bar to stop hikes completely will require more slowing of inflation that is broad-based (in both goods and services) and corroborated by a cooling off of the job market. – The enduring strength of the domestic jobs market is the critical US-centric downside risk to Treasuries. The lack of softening across many labor market metrics despite aggressive tightening, relatively elevated energy prices, and the retrenchment in global factory activity is putting the Federal Reserve on a path to keep interest rates higher for longer.
Ex-US Developed-market Bonds		– Outside the US, the threats of stagflation and recession are more pronounced. The European Central Bank is preparing to start quantitative tightening in Q1 while telegraphing a terminal policy rate above 3%. A new tool – the Transmission Protection Instrument – aims to compress unwarranted widening in periphery spreads relative to the core via asset purchases in order to increase the scope for rate hikes. – The Bank of England's apparent reluctance to deliver too much more policy tightening despite high wage growth and inflation is raising the probability that inflation risk is rerated higher. The Sunak government has outlined a spending plan that involves some fiscal consolidation, but much of this is back-loaded. – The Bank of Japan's recent expansion of its yield curve control range is a meaningful step towards a monetary tightening campaign in light of more entrenched inflationary pressures, in our view.
US Investment Grade (IG) Corporate Debt		– US IG all-in yields have become much more attractive given the rise in risk-free rates as well as widening spreads. We believe shorter-maturity IG debt is particularly attractive given the flat corporate curve and substantial income opportunity, especially given our view that the economy will remain resilient in the near term.
US HY Corporate Debt		– High yield spreads have widened materially from their mid-2021 lows. However, spreads are not close to levels that prevailed at the peak of growth scares in 2011 and early 2016. Global recession risks are as high now as they were during those periods.
Emerging Markets Debt US dollar Local currency		– 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. – A more positive carry backdrop for EM local bonds following rate hikes delivered well before developed-market central banks has increased the resilience of this asset class even in the face of aggressive global tightening.
China Sovereign		– Chinese bonds have been moving from a high yielder among major economies to a low yielder, diminishing the attractiveness of government bonds somewhat. – 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.
Currency		– We believe the US dollar has peaked, and has transitioned to an environment in which the USD is rangebound to lower. The catalysts for sustained USD depreciation (Fed tightening cycle over, fading energy pressures on Europe, and an end to China's zero-COVID policy) are starting to materialize. The Japanese yen is our most preferred currency given cheap valuations, BoJ tightening, and hedging properties. Some EMFX, like the Mexican peso, are poised to outperform select G10 FX like the British pound and New Zealand kiwi given attractive carry.

Source: UBS Asset Management. As of January 5, 2023. 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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