Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness

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Telegraphed taper no threat to the expansion

Highlights

- For equities, continued earnings growth is likely to outweigh any negative effects of a Fed taper.
- We believe that investors are underestimating the strength of the expansion, which is providing opportunities in procyclical positions.
- There are welcome signs of a shift to a healthier nominal growth environment ahead, with more real activity and ebbing inflationary pressures.
- In our view, a still slow-moving Fed and cyclical acceleration favors higher long-term bond yields and outperformance for pro-cyclical sectors and regions.

Investors are bracing for an inflection point in Federal Reserve policy, from adding monetary stimulus to gradually paring it back. This is not the 2013 taper tantrum, but a telegraphed taper.

A withdrawal of central bank stimulus is a natural, welcome consequence of a global economic recovery that continues apace – even as the Delta variant prevents a full normalization of activity. However, the low level of longer-term bond yields and equity market internals currently imply that that the economy is ill-equipped to handle even modest adjustments to this highly accommodative policy setting.

We believe this view is misguided. On its own, the nascent withdrawal of US monetary stimulus is not a threat to the economic expansion, as activity is likely to stay well above trend in 2022. As such, it is not a threat to the earnings growth that underpins the equity bull market.

A higher bar for hikes

The recent slowdown in US job growth should prevent any imminent hawkish Fed surprises, like an announcement on tapering at its September meeting or a particularly swift reduction in bond buying. However, the cumulative progress on inflation and employment since the depths of the pandemic have laid the groundwork for the Fed to begin reducing its asset purchases before the year is out.

Over a five-year horizon, PCE inflation has averaged above 2% – arguably aligned with the Fed's loosely-defined flexible average inflation targeting framework. What is important to remember is that on its own, that is not enough to get the central bank to hike rates. The bar for that is significantly higher. The Fed's forward guidance is three-fold: it states that the policy rate will stay at zero until (1) inflation has risen to 2%, (2) is on track to run moderately above that level for some time, and (3) the labor market has

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reached maximum employment. In his Jackson Hole virtual address, Fed Chair Jerome Powell stressed that that the criteria for tapering are quite different than what is required for rate liftoff, and that inflation is not the sole consideration.

At present, the US labor market is well short of its pre-pandemic state, and serves as the constraint on a more aggressive withdrawal of monetary stimulus. The central bank has yet to systematize any definition for full employment, and we would not expect one to be forthcoming. Rather, we expect that realized inflation outcomes will help to determine the central bank's view of what constitutes maximum employment – within reason. In our view, the Fed is unlikely to lift rates until the unemployment rate is below 4%, at a minimum, at a time when the inflation criteria listed above are also being met.

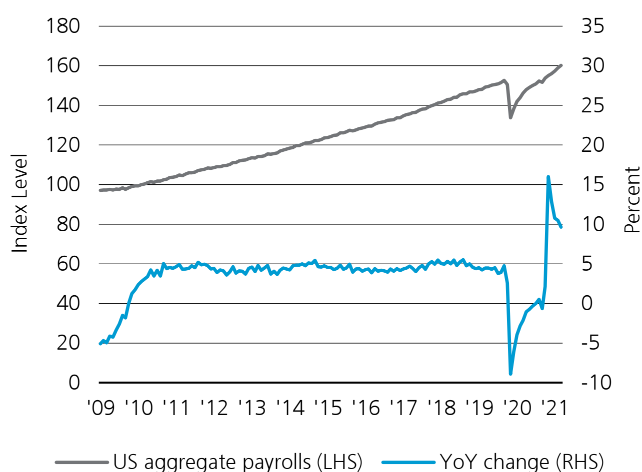
We believe that tapering will be announced near the end of this year and be carried out over 8 to 12 months. By the end of this period, we expect inflation will have cooled – particularly for core PCE inflation – as the reversal in idiosyncratic and reopening categories outweighs a continued rise in shelter inflation. After tapering runs its course, low inflation may prove a barrier to rate hikes, keeping monetary policy easier for longer.

Heathier nominal growth

The Fed's June meeting showed several officials were more sensitive to the surprisingly high price pressures associated with economic reopening and supply chain stresses than investors had previously thought. Soon thereafter, markets began to price more policy tightening in 2022 through 2023 than 2024 through 2025, and yield curves flattened aggressively.

A summary of the market's view is as follows: inflation that the Fed has to react to sooner rather than later is enough to undermine the economic expansion. Such a sequence of events is unlikely to be realized, in our view.

Exhibit 1: Growth in labor income to underpin consumption

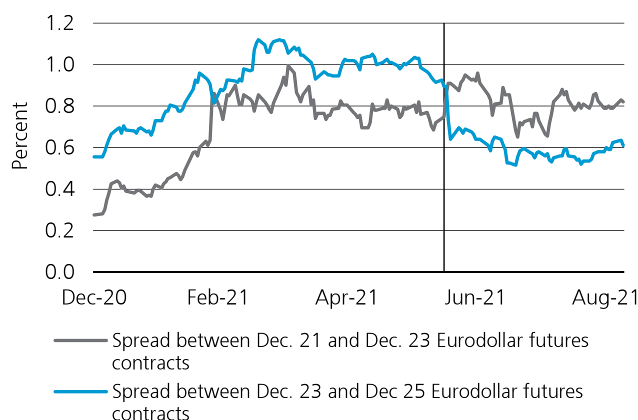


Source: UBS-AM, Bloomberg. Data as of 8 Sept. 2021.

We are cognizant that after last cycle's relatively sluggish expansion, the burden of proof is high for those espousing economic optimism. But investors do not appear to appreciate how the runway for strong activity is longer this cycle than in the aftermath of the 2007-08 global financial crisis. The US aggregate national paycheck is rising at nearly a 10% pace year-on-year, and has nearly eclipsed its pre-pandemic trend. The US consumer, the engine of global activity, is further bolstered by excess savings from previous income support measures. Businesses are running very lean inventories, which they have a need and desire to replenish. Continued supply disruptions, partially a function of this strong demand backdrop, will need to be durably remedied by investment that increases productive capacity.

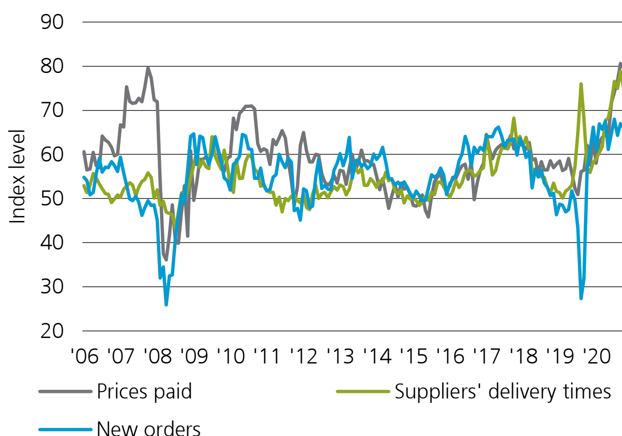
Elevated inflation would probably be a function of continued supply chain stress and strong demand that persists amid modest tightening. On the other hand, a shift to a more favorable composition of nominal growth – more real activity and less inflation – would allow for continued central bank patience on policy rates. We have seen encouraging signs on this front recently: the number of commodities reported to be

Exhibit 2: Investors price sooner but less Fed tightening after June meeting



Source: UBS-AM, Bloomberg. Data as of 8 September 2021.

Exhibit 3: Details of US ISM manufacturing report hint at better composition of nominal growth



Source: UBS-AM, Bloomberg. Data as of 31 August 2021.

in short supply at US manufacturers has decreased, as has the ISM prices paid index and suppliers' delivery times index. New orders, meanwhile, continue to expand at a robust clip. However, because of the ongoing pandemic, this progress may occasionally suffer setbacks.

Watch expectations

We believe that the most likely reason the Federal Reserve would turn hawkish is due to concern that its dual mandate goals are temporarily incompatible. For example, if above-target inflationary pressures were deemed to be more persistent than transitory, the central bank may take action to rein in inflation even if the labor market remained short of maximum employment.

A significant rise in longer-term inflation expectations is the key risk to gauge whether such an outcome would come to pass. Fed Chair Jerome Powell recently outlined an inflation expectations dashboard. This array of metrics is broadly in line with the Fed's price stability view, he said. If rising inflation expectations do become worrisome, we believe the central bank's guidance on the conditions required for rate hikes would be meaningfully altered well ahead of any change to monetary policy.

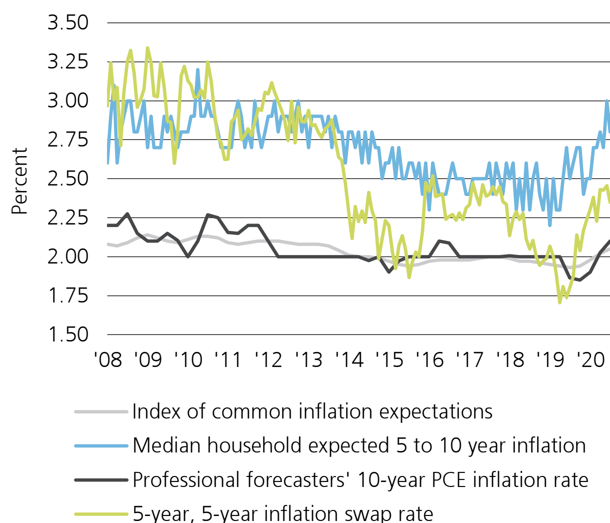
In our view, the deeply negative levels of US real yields, which protect the holder from CPI inflation, are inconsistent with the likely vigor of the global economic expansion, and are likely to move higher over time. Any adjustment in real rates would likely be more abrupt, meaningful, and disruptive to risk assets – and particularly secular growth stocks – if inflation expectations were at risk of becoming unhinged to the upside.

Conclusion

Investors are underappreciating the likely strength of economic growth, in our view, which is unlikely to be derailed by central banks tip-toeing away from the extraordinary easing policies.

By exhibiting patience on the removal of stimulus in the near term even as headline inflation remains elevated, the US central bank is accommodating an economic upswing. Over the course of the cycle, this may allow for more rate hikes

Exhibit 4: Inflation expectations remain well anchored



Source: UBS-AM, University of Michigan, Federal Reserve, Bloomberg. Data as of 6 September 2021.

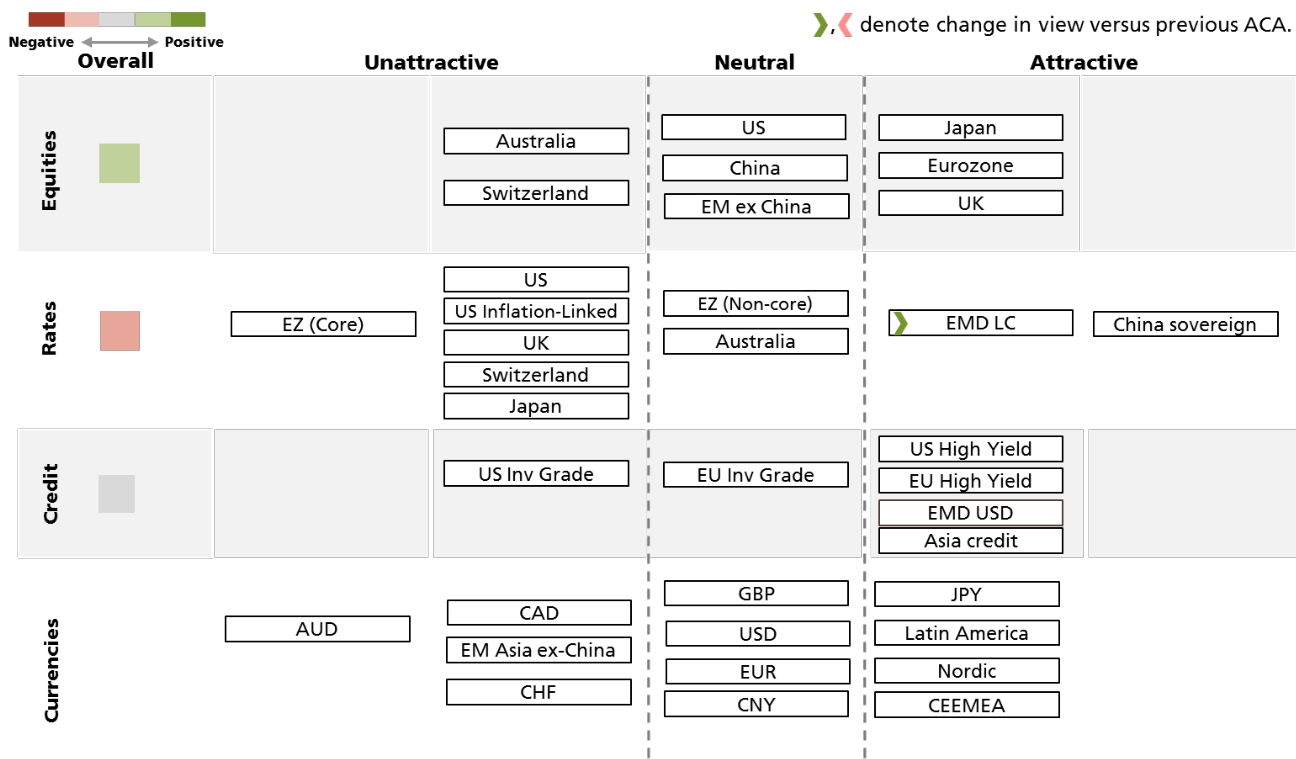
than if Fed officials acted aggressively and preemptively. As such, this policy setting should contribute to higher bond yields over time.

We see signs of a shift towards a healthier nominal growth environment that will allow for the Fed's structurally dovish monetary policy stance to persist. The gradual withdrawal of accommodation is not just a story of elevated inflation, but robust growth, as well. Cyclical assets are well-positioned to outperform during this strong expansion.

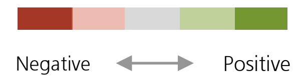
With the US economy in a relatively advanced phase, however, and real yields likely to rise, we find the risk-reward of short positions in the US dollar to be the least attractive cross-asset reflation trade. In our view, the risk-reward is better in relative equity regions such as Europe and Japan and sectors like financials and energy. These are procyclical segments of the market that should benefit from higher real yields, whereas secular growth stocks that dominate major US indexes will likely be more challenged in such a macro backdrop.

Asset class attractiveness (ACA)

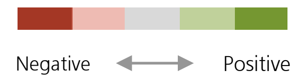
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 10 September 2021.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 10 September 2021. 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 signal	UBS Asset Management's viewpoint
Global Equities		– Our outlook for stocks over the next 12 months remains positive. The economic recovery is likely to continue this year on the back of additional global fiscal stimulus, still accommodative financial conditions, and progress on the broad administration of effective COVID-19 vaccines. – Improving earnings expectations are likely to underpin continued gains in global equities despite elevated valuations. The equity risk premium is near the floor of the previous cycle, which may cap upside as policy risks start to become more two-sided and growth momentum peaks. – Given the magnitude of the equity rally in recent months, we see more upside in relative value opportunities that offer attractively priced exposure to what will still be a very robust global growth backdrop compared to beta exposures.
US Equities		– US equities continue to command premium valuations. The sectoral composition drives this dynamic, with a higher weighting towards acyclical defensive technology than other markets. This characteristic may not prove a boon in the event that investors aim to boost cyclical exposure. Accordingly, we prefer US equal weight to market cap indexes. – Continued strong earnings, robust balance sheets, and unprecedented support from the Federal Reserve should continue to support US equities, but fiscal/tax policy risks are becoming more two-sided.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued and have significant exposure to the global economic recovery. – Earnings growth in Europe and Japan is poised to outstrip that of US, and this superior performance is not well reflected by the recent relative performance of these regions. – Both earnings and valuations have more room to run in ex-US developed market equities. – Improving vaccine administration should also bolster investor sentiment.
Emerging Markets (EM) Equities (ex-China)		– Solid growth in China even as stimulus ebbs, one of our macroeconomic themes, is a positive for the asset class, particularly for countries with the tightest economic and financial linkages. Resilience in industrial metals, even during a rally in sovereign bonds, is another leading indicator that points to a strong foundation for real activity. – However, EM equities continue to face near-term challenges that include a negative turn in forward earnings growth relative to DM, and less access to the most efficacious vaccines.
China Equities		– Policy actions designed to limit the power of major internet companies may linger as a headwind for this important pocket of the equity market. – The recent RRR cut may be an indication that the peak in credit tightening has passed. The upcoming turn in Chinese fiscal support and credit impulse should provide support for global cyclical assets. – We prefer international equities where the recoveries are less mature and earnings revisions are more supportive. – The new US administration will be more predictable in its relations with China, while continuing the process of economic decoupling in areas of strategic importance.
Global Duration		– Long-term bond yields have retraced aggressively ahead of the turn in global growth momentum and signs of incremental hawkishness from the Federal Reserve. However, inflation risks remain tilted to the upside and global economic activity is poised to remain robust well into 2022. – As such, we expect increases in real rates and market-based measures of inflation compensation to contribute to a renewed rise in yields. – Sovereign fixed income continues to play an important diversifying role in portfolio construction, and remains particularly effective in hedging downside in procyclical relative value equity positions..



Asset Class	Overall 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 Fed's responsiveness to inflation risks has undermined the appeal of curve steepeners until such a time that price pressures recede and economic activity remains elevated. – The looming peak in global growth, concerns about a potential Fed policy mistake, strong foreign demand, and over-extended short positioning have contributed to a sharp decline in US Treasury yields and flattening of yield curves. – We expect this to reverse going forward, with a combination of strong growth and inflation driving Treasury yields higher across the curve. – The Federal Reserve will likely lay out formal plans to taper its asset purchasing program by year end, and the extent of the deceleration in price pressures during the fourth quarter will play a key role in determining whether the removal of stimulus is expedited or delayed.
Ex-US Developed-market Bonds		– We continue to see developed-market sovereign yields outside the U.S. as unattractive. The Bank of Japan's domination of the Japanese government debt market and success in yield curve control diminishes the use of the asset class outside of relative value positions. The potential for European fiscal integration and solid commitment to supporting economies during the pandemic are factors that may compress periphery spreads, but perhaps at the expense of rising core borrowing costs, as well.
US Investment Grade (IG) Corporate Debt		– Spreads have fully retraced thanks to policy support and an improving economic outlook, while all-in borrowing costs are well below pre-pandemic levels. US IG is one of the few sources of quality, positive yield available and therefore a likely recipient of ample global savings. However, the duration risk embedded in high-grade debt as the economy recovers as well as the potential for spread widening should threats to the expansions arise serve as material two-sided risks that weigh on total return expectations for this asset class.
US High Yield Bonds		– We expect carry, rather than spread compression, to drive total returns in HY going forward. The coupons available will continue to attract buyers in a low-yield environment. – The asset class is more attractively valued and has less sensitivity to rising interest rates than IG bonds.
Emerging Markets Debt US dollar Local currency		– We have a positive view on emerging market dollar-denominated bonds due to the balance of carry opportunity and duration risk. – Asian credit is enticingly valued and poised to perform well in environments in which growth expectations improve or plateau, so long as highly adverse economic outcomes fail to materialize. – The more rangebound environment for the US dollar removes one previous tailwind for the outlook for total returns in EM local bonds.
Chinese Bonds		– Chinese government bonds have the highest nominal yields among the 10 largest fixed income markets globally as well as defensive properties that are not shared by most of the emerging-market universe. We believe that cooling domestic economic growth and inclusions to global bond market indices should put downward pressure on yields during the next 3-12 months.
Currency		– The Federal Reserve's signal of concern about inflation risks, as seen by the increase in the 2023 median for the dot plot, puts a higher floor under the dollar and meaningfully reduces the prospect of a retest of its late-May lows in the near term. – EMFX like RUB and BRL, which are supported by continued monetary tightening, are well-positioned to outperform even in a rangebound USD environment, while cyclical Asian currencies and select G10 commodity exporters are poised to struggle.

Source: UBS Asset Management. As of 10 September 2021. 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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