Macro Quarterly

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

Macroeconomic themes and tactical asset allocation opportunities
1Q2021 | UBS Asset Management

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New year, same early-cycle recovery

Highlights

– Success in vaccine development means a return to economic normality is a matter of when, not if.
– Accommodative monetary and fiscal policy should continue to provide a strong foundation for a vigorous recovery and hand-off to private demand and services-led growth.
– Democrats have now secured control of the Senate which bolsters the prospects for even more fiscal relief as well as further stimulus to augment the recovery. In addition, it increases the risk of higher taxes as well as tougher antitrust enforcement.
– We favor classic early-cycle beneficiaries like value stocks, non-US equities, and emerging market currencies.
– Most identifiable risks in 2021, such as delays in vaccine administration, are concerned with the timing and intensity of the economic rebound as opposed to whether it can be sustained, so corrections tied to those catalysts are likely to serve as opportunities to increase exposure to procyclical positions.
– This reflationary view will face more challenges as the year progresses, particularly if a telegraphed withdrawal of fiscal support dampens the outlook for 2022. A sharp spike in US real yields, while consistent with procyclical relative positioning, could undermine headline equity valuations given their substantial weighting towards long duration equity sectors.

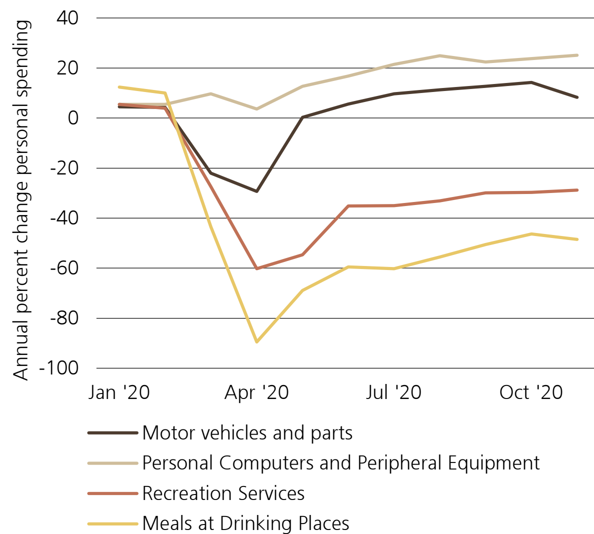
In 2020, economic damage was driven by the need to flatten the infection curve. The evolving expansion in 2021 is tied to the steepening curve of vaccinations.

We enjoyed success in our procyclical positioning in the second half of 2020, as we expected investors to be able to look through near-term difficulties to the broadening, durable recovery around the corner. Conviction in this view will inevitably be tested in 2021 by the challenges of vaccine administration, the potential for ebbing global fiscal and monetary stimulus, and other hitherto unforeseen obstacles. We are prepared for market volatility should the identifiable risks on the horizon be realized, which could cause detours along the path to normalization but not an economic downturn.

This direction of travel is positive, and we believe it provides an attractive backdrop for risk assets. The trade set that historically has performed well in an early-cycle environment includes US dollar weakness, value over growth, small caps vs. large, non-US risk assets over their US counterparts, cyclical stocks vs. defensives, and a steepening yield curve. We believe that these typical beneficiaries have substantial room to run on the nonlinear but eventual progress towards pre-pandemic norms.

UBS

Exhibit 1: Spending strength to shift from goods to services in 2021



Source: Bloomberg, UBS Asset Management. As of 30 November 2020.

Our conviction in this positioning has risen after the Georgia Senate runoffs, raising the likelihood of additional fiscal stimulus and stronger growth. Setbacks in these reflationary positions are likely to be buying opportunities, in our view.

Trending towards normal

Medical innovation has seemingly alleviated the biggest economic risk linked to COVID-19 – a permanent change in historical patterns of behavior and activities with no end in sight. Herd immunity from COVID-19 is now a matter of when, not if.

Pandemic-induced restraints will eventually dissipate as the inoculation process gains traction. A burst of strength in supply-constrained services sectors after robust activity in goods sectors will mark the start of a transition in which growth is rebalanced towards a more pre-pandemic composition.

Expansive monetary and fiscal stimulus should ensure the bridge towards normalization is long and strong enough to weather a seasonal upturn in COVID-19 cases, complicating virus mutations, and any delays in vaccinations that arise in the interim. Importantly, the additional stimulus package passed by US Congress during the lame-duck session bolsters our belief that the early-cycle growth phase will be vigorous once the latter portions of this shock have passed.

The Democrats are poised to gain control of the Senate following victories in the Georgia special elections. A unified Democratic government adds an additional catalyst for our procyclical positions, but may also be a temporary source of volatility for US equities at the index level.

More fiscal relief in the near-term is now likely, in our view. We expect the new Congress to quickly pursue a package that extends enhanced unemployment insurance benefits, provides support for state and local governments, and also larger stimulus checks to households.

On the other hand, this electoral outcome increases the risk of higher US taxes as well as more stringent antitrust efforts against big technology firms. We expect, at worst, relatively modest increases in corporate and personal tax rates, since the balance of power rests in the most moderate Democrat Senators. Importantly, any revenues raised will likely be offset by additional spending on initiatives like green infrastructure, supporting the US and global recoveries.

We believe that Europe's more collectivist approach to fiscal policy will begin to bear fruit in 2021, and EU restrictions that limit national borrowing will stay suspended. China has also pledged that while credit growth will slow, there will be no abrupt departure from its macroeconomic stabilization initiatives.

The Federal Reserve (Fed) has indicated that it will not overreact to any short-term burst of inflation in 2021, and will wait for more persistent signs of price pressures before considering the withdrawal of stimulus. Other developed-market central banks are also poised to maintain highly accommodative policy in order to help foster the strongest and most widely-shared recovery possible. In doing so, they will be buoying procyclical forces in 2021 simply by standing still as the expansion gains traction, inflation picks up, and realized real rates decline.

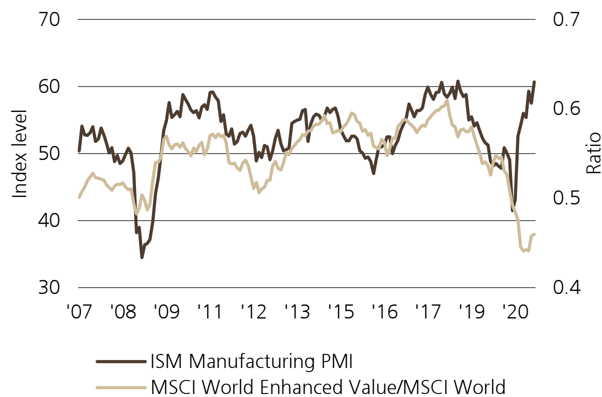
Detours, not downturns

The identifiable risks in 2021 surround the timing and intensity of the economic recovery rather than posing an existential threat to the nascent expansion. As such, we would expect them to spark only short-term bouts of risk aversion; diversions from an early-cycle backdrop that should continue to benefit procyclical positions.

For instance, we expect that a material share of the population in advanced economies will be vaccinated around mid-2021, with variable lags for different emerging market economies. Persistent sluggishness in the roll out of vaccinations could force investors to scale back any optimistic expectations on the timetable for a return to normal. This would likely challenge the procyclical trade set. There are material logistical challenges at every step of the process: production, distribution, and administration. Issues in the latter two phases have led to the US falling far short of its goal to administer 20 million shots in 2020. These problems may grow more intense as all aspects of the process attempt to scale, or may lessen as different candidates become available.

There may also be an uneven handoff in the rebalancing of growth if the withdrawal of Chinese policy support precedes sufficient vaccinations and the normalization of services sectors in developed economies. The temporary absence of a meaningful global growth impulse may interrupt, but not derail, cyclically-oriented positions.

Exhibit 2: Ample room for value stocks to catch up to rebound in manufacturing activity



Source: UBS Asset Management, Bloomberg. As of 31 December 2020.

Exhibit 3: Value stocks trade at discount to growth not seen since dot-com bubble

Source: UBS Asset Management. Data as of 31 December 2020.

Investors could choose to focus on some of the market-unfriendly implications of a unified Democratic government, which include the potential for higher taxes and regulatory scrutiny – particularly for technology giants. This would likely disrupt some of our pro-risk positions given the weight of these companies and US stocks in global benchmarks, while our more procyclical relative value positions may benefit from greater government spending and stronger economic growth.

On the other end of the spectrum, robust fiscal stimulus, expedient progress on vaccinations, and a base effect-driven upturn in inflation could fuel a disorderly spike in bond yields as investors pull forward expectations on the timing of the tapering of monetary stimulus. Any negative spillover effects on risk assets would be temporary, in our view. We believe the Fed will be quick to push back against a rise in bond yields that is sharp, contributes to a broad tightening of financial conditions, or challenges its forward guidance to keep rates on hold until the dual mandate goals are achieved. Establishing the credibility of its structurally dovish shift to flexible average inflation targeting will require evidence of the central bank following through on its commitment by allowing price pressures to be sustained.

Risks to our outlook will increase by the middle of the year as investors begin to price in how much global growth will decelerate in 2022. Indications as to how swiftly and how much fiscal support may be withdrawn will be among the key signposts that determine the longevity of the procyclical trade set. Reflation trades may peter out if the lasting structural change from COVID-19 proves to be the pulling forward of market share gains for technology firms rather than a regime shift towards expansionary fiscal policy.

We would revisit our risk-on stance if, contrary to our expectations, vaccines proved ineffective against mutations of the virus, global governments quickly pivoted towards austerity, or real yields were to sharply rise.

Asset allocation

Low real rates and our expectation for continued economic growth and increasing earnings lead us to favor equities and credit relative to sovereign bonds and the US dollar. Valuations in risky assets may appear on the expensive side compared to history but they are not in the context of still low bond yields.

Within our preferred asset classes, the stage of the cycle and the relatively accommodative fiscal stance help steer us towards the more reflationary areas of the market, with a tilt towards value and non-US stocks as well as credit. We favor emerging market equities, particularly ex-China, vs. developed market counterparts. The high levels of implied volatility that persisted in 2020 due to COVID-19 and the US election should also ease following the Georgia vote on enhanced confidence and visibility into a comprehensive recovery.

We expect this thesis to be tested by aforementioned risks or unexpected ones, but emerge intact. Most diversions should be viewed as buying opportunities. This is the start of an economic upswing, and the early-cycle trade set should continue to outperform.

Value stocks are still lagging the degree of success that would be expected based on earnings revisions and the change in manufacturing activity, while trading at a discount to growth stocks not seen since the dot-com bubble. A superior earnings recovery in the near term amid a robust economic expansion could serve as a catalyst for a rerating of value stocks and hefty outperformance. Further out, the speed, breadth, and endurance of the combined policy response deployed during this shock may reduce the amount and persistence of earnings declines for cyclically-oriented companies in subsequent downturns, if this crisis-era pandemic playbook is used as a future blueprint.

Conclusion

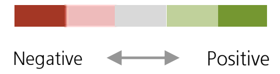
We believe 2021 will bring about the realization, and in some cases, continuation of many trends we anticipated would unfold in early 2020 before the pandemic derailed all macro prognostications. And for the same reasons, to boot: An expected cyclical upturn leaves us constructive on global equities, and should disproportionately benefit non-US stocks and weigh on the US dollar.

Changes in the fundamental backdrop over the past year have made these relative value opportunities even more compelling and resilient to shocks.

The degree of policy support provided in 2020 increases our conviction in superior earnings growth and outperformance of more cyclically oriented sectors and country indexes going forward. And because of the past price performance, the valuation discrepancies are even wider, creating a more attractive opportunity with a higher margin of safety,

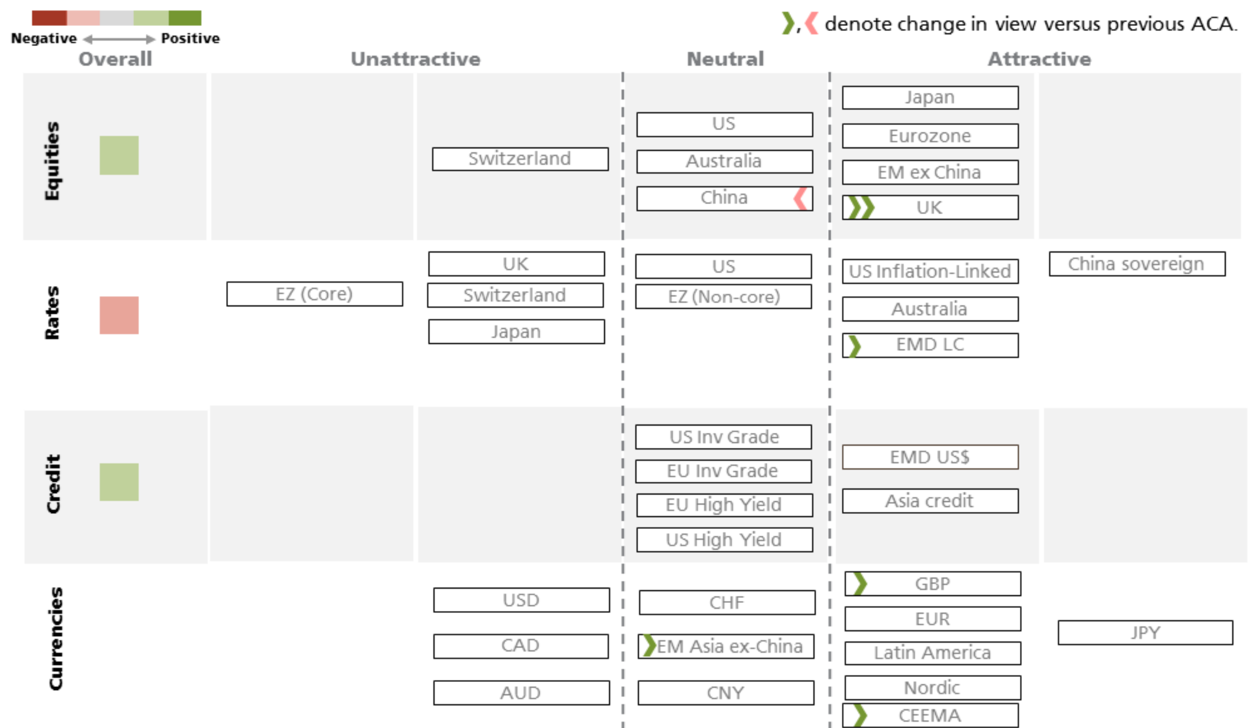
The observed interest rate convergence, reinforced by a structural dovish policy shift from the Federal Reserve, should leave the US dollar out of favor, especially compared to high-beta emerging market currencies.

We believe sticking with a procyclical playbook through most obstacles that may emerge in 2021 is the best approach, as vaccination efforts allow economic momentum to be reclaimed.

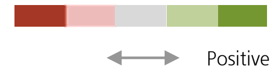


Asset class attractiveness

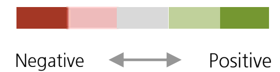
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 4 January 2021.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 4 January 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 12m 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. – The global economic recovery to date has been stronger than expected, which we believe is not fully reflected in the performance of more economically-sensitive segments of the equity market. We remain focused on relative value opportunities that offer attractively priced exposure to the turn in global growth.
US Equities		– US equities continue to command premium valuations. The sectoral composition drives this dynamic, with a higher weighting towards a cyclical defensive technology than other markets. This characteristic may not prove a boon in the event that investors aim to boost cyclical exposure. – Nonetheless, continued strong earnings, robust balance sheets, and unprecedented support from the Federal Reserve should continue to support US equities. – We prefer US small caps, which have stronger ties to the expected improvement in the domestic economy than their large-cap counterparts.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued and have significant exposure to the global economic recovery. – Negative COVID19 developments in Europe are well-reflected in asset prices. National budget plans point to solid, sustained fiscal support in 2021, with disbursements from the recovery fund also enhancing the outlook for activity on the continent. – Japanese stocks are attractively valued and have improving corporate fundamentals, with the domestic economy buoyed by substantial fiscal stimulus. – The incoming US administration's policy priorities should remove some of the lingering US protectionism discount embedded in international risk assets and boost the global growth outlook.
Emerging Markets (EM) Equities (ex. China)		– The stabilization of growth in China, one of our macroeconomic themes, is a positive for the asset class, particularly for countries with the tightest economic and financial linkages. The strong rally in industrial metals is another leading indicator that points to a solid foundation for real activity. – EMs show a less negative trend in earnings expectations, trade at reasonable valuations, and may also benefit from an ebbing of protectionism from the incoming administration.
China Equities		– China's superior fiscal and monetary capacity to respond to shocks along with its first-in, first-out status on the global pandemic allowed domestic equities to perform well in 2020. – We expect continued gains so long as there is no abrupt withdrawal of accommodation, but with the recovery in a more mature phase we prefer ex-Chinese emerging market equities. – The risk of measures against China by the outgoing US administration during the transition period is elevated. – State support for fostering a healthy bull market and the ensuing pickup in retail activity may also spur two-way volatility.
Global Duration		– The long end of sovereign curves can serve as a release valve for any signs of economic optimism as central bank commitments to keep policy rates low remain credible. – Nonetheless, sovereign fixed income continues to play an important diversifying role in portfolio construction. Inflation-linked U.S. debt is preferred to plain vanilla Treasuries, given the likelihood that any sustained back-up in yields will be concentrated in inflation breakevens.



Negative ⟷ Positive

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. We expect a continued steepening in the yield curve as the global recovery gains traction, while flexible average inflation targeting increases the potential risk to the long end of the curve over time. Scope for sustained divergence of US yields from their global peers appears to be limited. The Fed's immense quantitative easing is an important countervailing force against even more dramatic issuance. Tweaks to the central bank's asset purchase program or explicit messaging would likely be deployed to limit any increase in yields deemed detrimental to the burgeoning recovery.
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 retraced materially thanks to enduring Fed support amid an improving economic outlook. Even after a surge of issuance, 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. The coupons available will continue to attract buyers in a low-yield environment. – The asset class is vulnerable to lingering concerns about the durability of the economic rebound amid additional waves of the pandemic, which may result in renewed solvency risks in pockets of the universe.
Emerging Markets Debt US dollar Local currency		– Emerging market dollar-denominated bonds and Asian credit are 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. – From the perspective of USD-based investors, we expect total returns in EM local bonds will be enhanced by exchange rate movements.
Chinese Bonds		– Chinese government bonds have the highest nominal yields among the 10 largest fixed income markets globally and have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. The nation's sovereign debt has defensive properties that are not shared by most of the emerging-market universe. We believe that slowing economic growth and inclusions to global bond market indices should put downward pressure on yields during the next 3-12 months.
Currency		– Foreign exchange markets provide the cleanest expressions for relative value positions across a variety of themes and time horizons, particularly protection in the event downside risks manifest. – We have high conviction that the shrinking US yield premium, global turn in activity, and lessening protectionism risk premia herald a sustained turn in what is a still overvalued US dollar. We expect higher-beta EM currencies will continue to outperform against the dollar on progress towards a return to pre-pandemic norms.

Source: UBS Asset Management. As of 4 January 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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