

Macro Monthly

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

UBS Asset Management | Economic insights and asset class attractiveness
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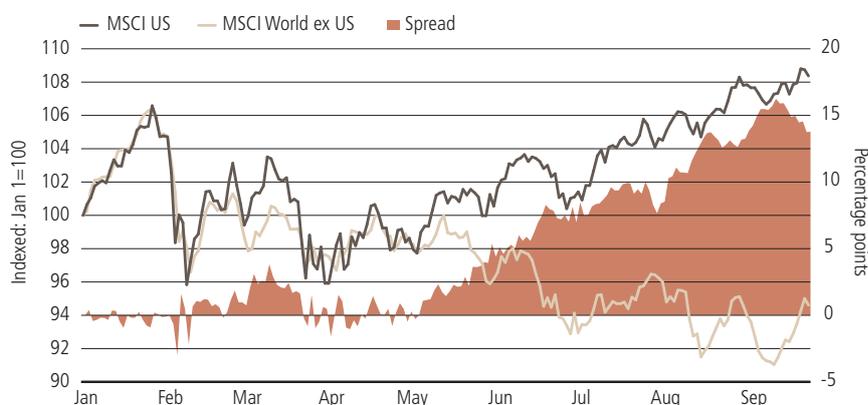
US equity outperformance: Should investors mind the gap?

Highlights

- Asset market divergence between the US and the rest of the world has been driven by de-synchronized global growth, escalating trade tensions and regional sector compositions.
- While periods of US equity outperformance are common, the scale of recent divergence is rare historically. But prior instances of comparable divergence do not provide a dependable guide as to when and how re-synchronization occurs.
- We do not yet see clear signs in the global economy to suggest that recent US outperformance is definitively over, even if its momentum may slow.
- We await signs that China's stimulus is taking effect in cushioning ex-US growth, and/or that trade tensions are beginning to meaningfully dent the US economy, before we are convinced that US and ex-US market performance will re-converge.

2018 has been a year of stark divergence in asset performance for the US versus the rest of the world (RoW). Year to date, the MSCI US equity index has outperformed the MSCI ex US by 13% in dollar terms (exhibit 1). The spread between 10-year nominal Treasury and bund yields has widened by 60 bps and now hovers near 30-year highs. And the dollar staged a powerful counter-trend rally, contributing to widespread weakness across emerging markets asset classes. In this Macro Monthly, we examine what is behind this widening asset divergence, what history tells us about these kinds of divergences, and what we believe will be the likely drivers of relative performance over coming quarters.

**Exhibit 1: MSCI US Equity vs. MSCI World ex US (in USD terms):
Indexed to 100**



Sources: Bloomberg LLC. Data as of Sept. 27, 2018.

The simplest explanation for US equity outperformance this year is economic divergence that has translated into equally divergent corporate earnings profiles. The synchronized global growth of 2017 ended abruptly earlier this year, with economic data disappointing in much of the rest of the world, in part driven by the lagged effects of Chinese deleveraging. Meanwhile, US economic growth accelerated on late-cycle fiscal stimulus (Exhibit 2). Against this backdrop US company profits have grown strongly – beating even upbeat expectations over the past few quarters – while corporate earnings outside of the US have stuttered and in the case of Europe, disappointed.

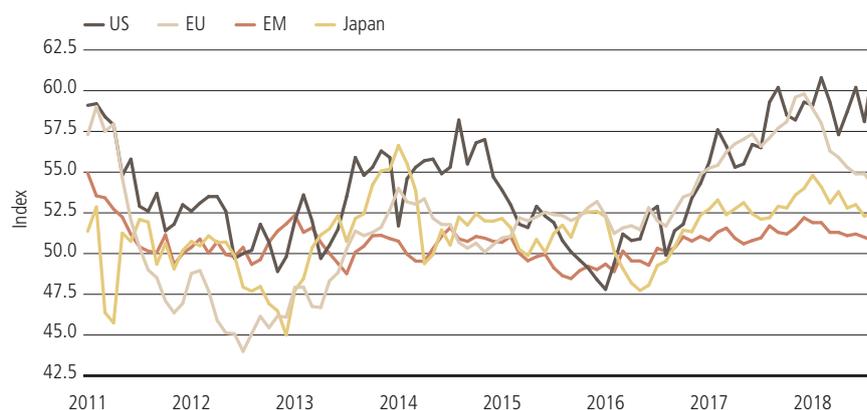
Increased trade tensions have also played a role, with the market judging that tit-for-tat escalation of tariffs will disproportionately affect more trade-dependent nations than the US. China is now engaging in monetary and fiscal stimulus to cushion its economy against the effects of prior de-leveraging and trade tensions, which could help offset some of the recent US-RoW growth imbalance.

Specifically within equities, the persistent outperformance of growth versus value is naturally beneficial to the US, where a higher percentage weight in fast-growing Information Technology companies relative to more value-heavy indexes like Europe and Japan will naturally favor US outperformance. Indeed, using an equal-sector weighted rather than market-capitization weighted index comparison between the US and the RoW, one can see that much of the outperformance from the US over the last couple of decades can be attributed to the growing index weight of tech, which typically trades at a higher price-to-earnings multiple relative to other sectors (Exhibit 3).

What does history tell us?

We examined periods of US equity outperformance versus the RoW (Exhibit 4) and make a few observations. First, multi-quarter periods of US-RoW outperformance are not uncommon

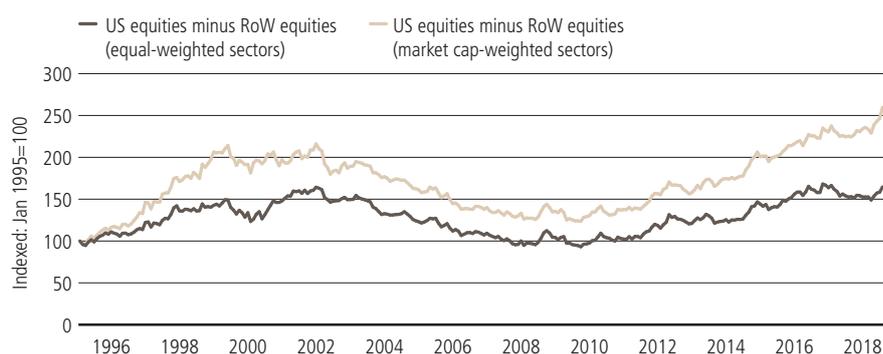
Exhibit 2: Global manufacturing PMIs



Sources: UBS Asset Management, Macrobond. Data as of August 31, 2018.

Exhibit 3: The growing weight of tech explains much of US outperformance over recent years

Relative performances (adjusted for volatility)



Sources: UBS Asset Management, Bloomberg LLC. Data as of August 31, 2018.

(nor are periods of RoW-US outperformance). That said, the magnitude of recent divergence (double-digit % outperformance) over two quarters, is fairly large relative to history. Since late 1990s, we have only seen two instances in which a separate six-month period had a divergence of greater than 10% (in earlier decades, such outperformance was more common). In both cases, we did not observe strong mean reversion in the following quarters; in fact, momentum can continue for some time, and since the post 2007-08 financial crisis period in particular, there were more

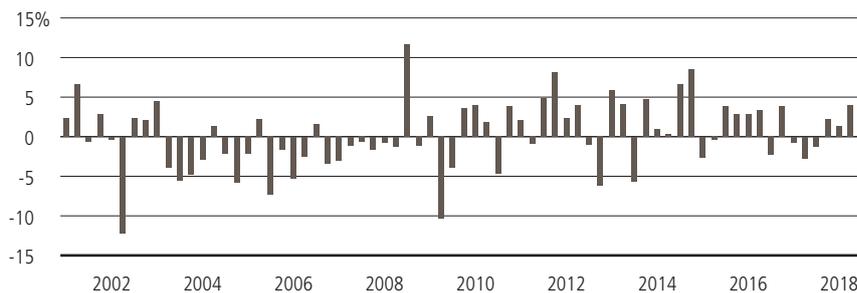
periods of US outperformance than otherwise. In any case, simply looking at historical data can tell us how unusual certain behavior is relative to history, but it may not always be a great indication of the future. This is especially true if the underlying drivers of such behaviors change over time. As usual, our view on whether US outperformance is likely to continue will come down to our assessment of how we expect macro and financial themes to develop across regions versus what is currently priced in.

The outlook from here

At the moment we think the US is in the midst of a positive feedback loop between a robust economy and still accommodative financial conditions. Strong economic performance has boosted confidence to borrow and invest while broad financial conditions remain easy even amid Fed hikes. While we recognize that plenty of good news is in the price, and the economy is later cycle, we do not want to stand in the way of this 'positive reflexivity' until we see clear signs of a breakdown in leading indicators including business and consumer confidence. Perhaps this will be the case if the US business community more fully takes into account the impact of recent trade escalation and slows investment and employment plans, evidence of which we have yet to see. And while we recognize relative valuations between value and growth are extreme, we are not confident there is a powerful enough catalyst (such as materially higher rates or a spike in tech regulation) to reverse these trends in the near term. Note as well that despite another strong year of outperformance, US equities are now more attractive than they were after profits have grown faster than share prices have risen (as measured by the twelve month forward P/E ratio). This suggests that US equities can continue to perform, even if recent momentum moderates somewhat.

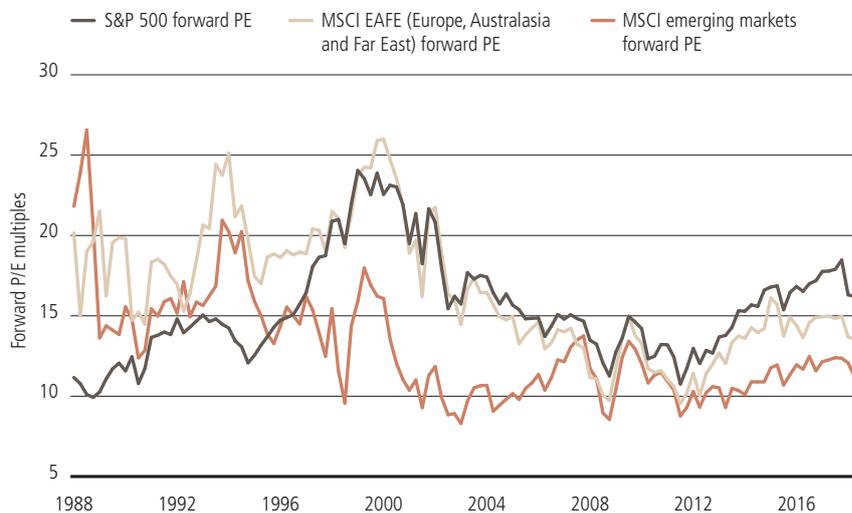
When looking at the rest of the world, we acknowledge that a lot of bad news is in the price, and that valuations have adjusted. And our thesis remains that overall global growth, including outside the US, will remain above trend as still easy monetary conditions in developed markets and China's monetary, fiscal and regulatory stimulus cushion growth against prior deleveraging and escalating trade tensions. Based on this outlook

Exhibit 4: Quarterly performance between US and RoW equity markets



Sources: UBS Asset Management, Macrobond, MSCI. Data as of August 31, 2018.

Exhibit 5: 12-month forward P/E by region



Sources: UBS Asset Management, Datastream. Data as of September 27, 2018.

and more attractive valuations, we are constructive on Japan, emerging markets and Europe over our 12-month tactical horizon. But in order to move materially overweight these regions relative to the US, we want to see more evidence of growth stabilization, which has been tentative so far. Over the coming quarter, we are keeping a close eye on China's credit data, raw industrial commodity prices, and ex-US developed market consumer and business confidence as key indicators of growth stabilization. And of course, geopolitical risks such as potential further trade escalation and an exacerbation of tensions between Italy and European authorities bear close monitoring.

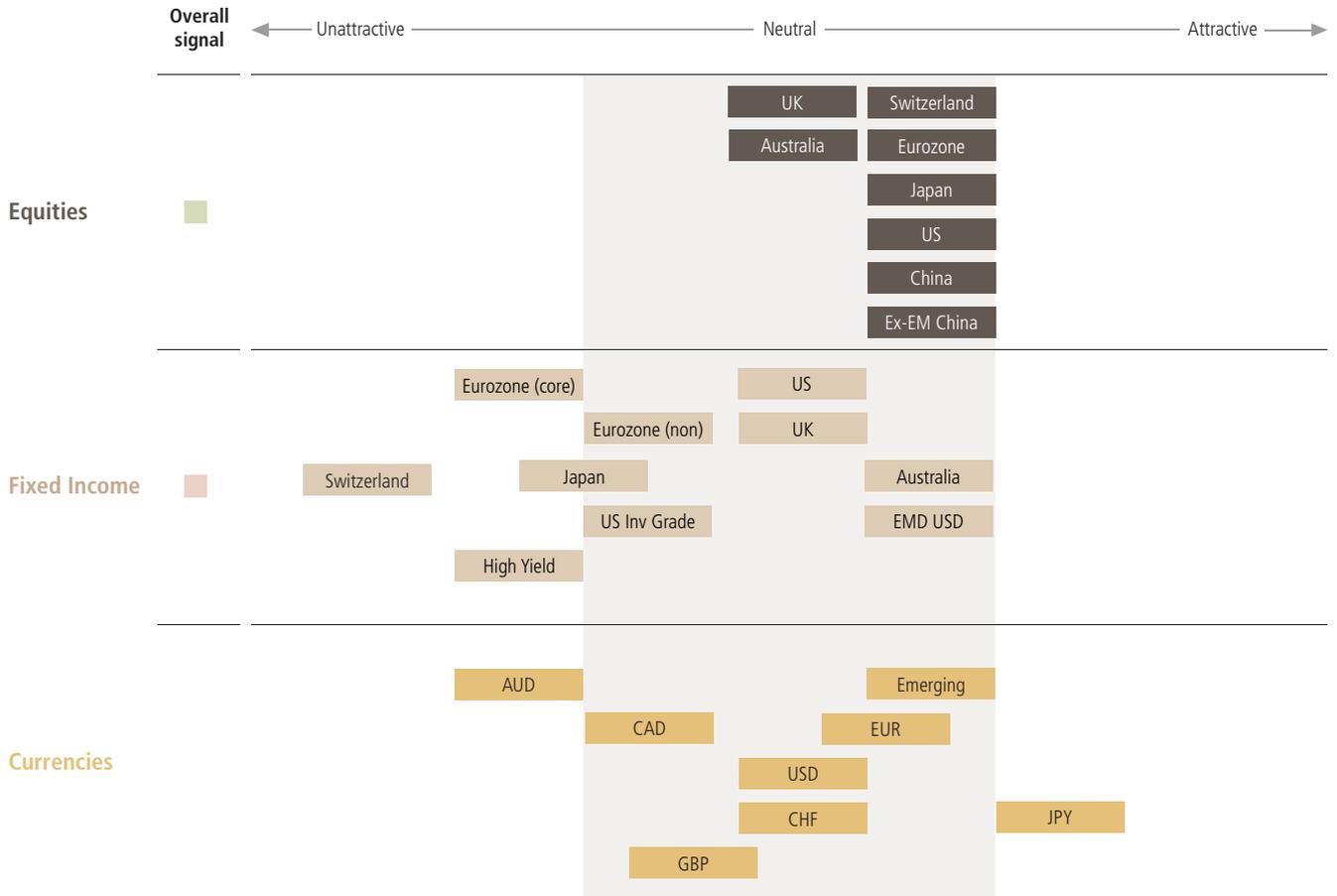
The bottom line: Asset allocation

On a global basis, we remain constructive on equities given above-trend global growth, still easy financial conditions, and limited recession risks over the next year. But despite strong US outperformance year to date and less attractive valuations compared to other regions, we are not looking to be actively underweight the US versus Europe, EM or Japan at the moment. Our focus remains on economic data: If we see genuine signs of stabilization in China and ex-US developed markets, or perhaps a greater appreciation of tariff risks in the US economy, we would be more inclined to shift relative preferences. Likewise, a durable pickup in inflation in Europe and Japan would give us more conviction in entering bond convergence trades, to take advantage of historically wide spreads. Ultimately we expect the time for convergence to come, but we are not convinced it has arrived just yet.

Overall signal = Positive ← → Negative

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 September 30, 2018.



Source: UBS Asset Management Investment Solutions Asset Allocation team as at September 30, 2018. Views are provided on the basis of a 12-18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change. For illustrative purposes only.

Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		<ul style="list-style-type: none"> While the US economic cycle is mature, both consumer spending and corporate capital expenditure appear well supported by recent tax reform. The latter in particular gives grounds for optimism in future US productivity growth and in the sustainability of the cycle. Stronger-than-expected corporate earnings growth, rising M&A, improving manufacturing activity and increasing capital returns to shareholders are likely to remain key supports in the coming months. More importantly in our view, US equities remain attractively valued relative to bonds despite the recent rise in yields.
Global (Ex-US) Equities		<ul style="list-style-type: none"> In Europe, the increased risk premium prompted by recent political developments in peripheral Europe will likely constrain upside potential until more clarity emerges around the fiscal intentions of the new Italian government. Despite these short-term headwinds, our longer-term base case remains positive, supported by demand growth that is still above-trend, and the potential support to earnings from balance sheet optimization. With political uncertainties around Abe's re-election gone, we view Japanese equities as attractive. On-going structural reforms support a higher rating while building economic momentum suggests the outlook for profits growth is stronger than markets are currently discounting.
Emerging Markets (EM) Equities including China		<ul style="list-style-type: none"> Emerging market equities have struggled in recent months in the face of a strengthening USD, rising USD funding rates and rising geopolitical risks. We do not dispute that these factors present headwinds. But in aggregate, fundamental conditions remain relatively robust and the recent share price weakness across EM feels out of kilter with these fundamentals. We no longer have a clear preference for Asia (ex China) within the broader EM universe. In our view, attractive valuations are now at least partially countered by vulnerability to any escalation in the US/China trade war. We remain broadly positive on China. Any broadening of the current trade stand-off with the US is likely to hamper Chinese growth, but a gradual economic slowdown is already priced in and the Chinese authorities have already shown themselves willing to boost liquidity to help smooth the on-going economic transition. Chinese equities still trade at a PE discount to other markets and further market liberalization could prompt a rerating as international capital starts to flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
US Bonds		<ul style="list-style-type: none"> US Treasury yields remain low by historical standards, but look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pick-up in inflation, yields are likely to remain range bound. Our overall assessment is neutral.
Global (Ex-US) Bonds		<ul style="list-style-type: none"> In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB has committed to low rates into next year, so we see limited opportunity in Europe. Swiss bonds continue to look very overvalued and in our view they have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalise monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market. Elsewhere we are more positive on Australian and Canadian duration on a relative basis. In our view, both economies are vulnerable to a housing market correction after very strong recent performance.
Investment Grade (IG) Corporate Debt		<ul style="list-style-type: none"> Geopolitical turmoil and trade issues have spilled over into the credit markets, causing IG spreads to widen slightly in recent months. Although we do not believe that a sharp demand slowdown is imminent, we retain a neutral view on credit.
High Yield Bonds		<ul style="list-style-type: none"> Current default rates in High Yield are very low by historical standard. Given the relatively positive economic backdrop, we do not expect any material pick-up in US corporate debt defaults in the near-term. However, while spreads have widened in recent weeks, we do not yet view the risk/reward as attractive.
Emerging Markets Debt US dollar Local currency		<ul style="list-style-type: none"> Spreads on EM debt relative to US treasuries have widened substantially in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates – sparking particular fears for EM countries with large external funding requirements. Nonetheless, we see continued strong demand for EM debt's attractive real yield on a selective basis.
Currency		<ul style="list-style-type: none"> We expect global growth to re-synchronize over coming quarters, with ex-US economies showing initial signs of stabilization. We anticipate capital will flow from the US into earlier-cycle economies, especially as the USD remains somewhat expensive on a real trade-weighted basis. Elsewhere, we continue to see strong valuation support for the JPY.

¹ Source: UBS Asset Management. As of September 30, 2018.

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Americas

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