# 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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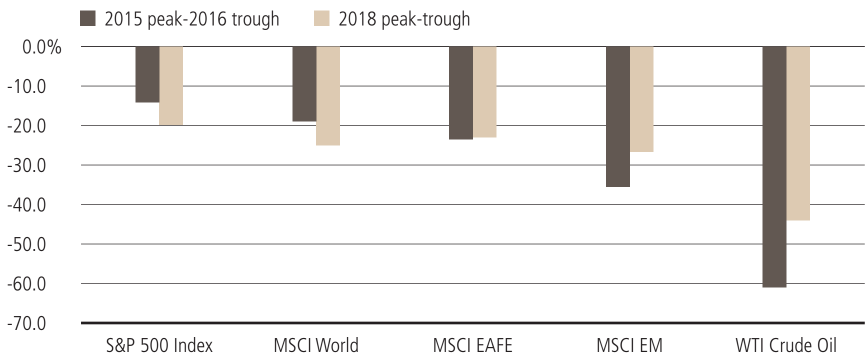
## Something familiar

**Highlights**

- The market and economic environment is reminiscent of the late 2015 and early 2016 period.
- The global economy is in better shape this time around and equity valuations more attractive, but tighter policy and geopolitical tensions are headwinds.
- Three years ago, a one-two punch of a less hawkish Fed and China stimulus catalyzed a quick rebound in risk assets toward their highs.
- We expect policymakers on both sides of the Pacific to once again provide support for risk assets in 2019, but policy constraints may limit the effectiveness compared to 2015/16.

While the sharp drawdown in global risk assets in the fourth quarter of 2018 stands in stark contrast to their placid uptrends in 2017, there is still something familiar in recent price action. In several ways, market behavior late in 2018 and to start 2019 resembles that of late 2015/early 2016. Exhibits 1 and 2 show the drawdowns for major asset classes in 2015 until early 2016 compared to drawdowns in 2018. Drawdowns across global equity indexes in 2018 have generally been more severe than those of three years ago, while the rise in credit spreads and decline in Treasury yields have been roughly half those in the prior period. A sharp decline in oil prices, driven by both supply and demand factors, has been a common element that has fed into weakness in the prices of risk assets. Arguably, the underlying concerns among investors in these two periods are similar as well—fears of a Fed policy mistake amid slowing global growth.

**Exhibit 1: 2015-2016 vs 2018 peak to trough equity performance**




Source: Bloomberg as of December 26, 2018.

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In Q1 2016, these concerns began to fade driven by a more dovish Fed and evidence of an improving global economy. Indeed, risk assets rebounded rather quickly towards their previous highs. Today there are enough similarities to ask the question of whether history might repeat itself, but enough key differences which we believe are likely to make the healing process for global risk assets longer and bumpier than three years ago. This Macro Monthly compares the macro backdrop, policy dynamics and valuations over the two periods and discusses implications for asset allocation.

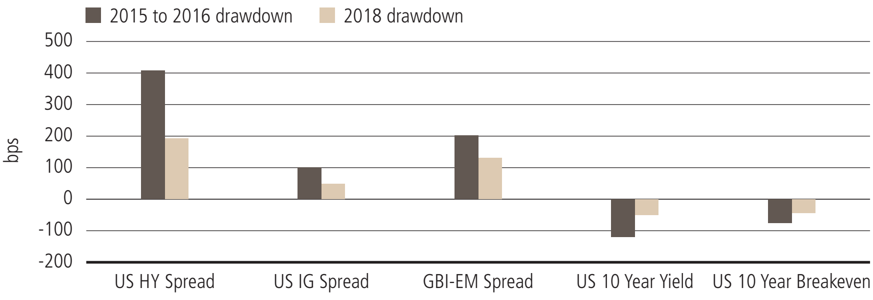
### The macro backdrop

The stock market is certainly not the economy. But over time, equity market performance tends to broadly reflect the prospects of company earnings, which generally move in line with nominal economic growth. So a useful starting point is to examine where the global economy stands versus three years ago. Put simply, the economy is looking a lot healthier than it was back then. By the middle of 2015, global composite Purchasing Manager Indexes (PMIs) had declined sharply, and emerging markets turned below the key 50 level separating expansion and contraction. In contrast, today's PMIs, while down from elevated levels, remain comfortably in expansionary territory. Likewise, while nominal export growth for large economies had turned negative in 2014, it currently remains in positive territory. And while China's economy is slowing, its nominal GDP growth as of Q3 2018 was far above where it was three years ago, near post-crisis lows. Meanwhile, developed market consumers are in very good shape today, with incomes rising healthily across the US, Europe, Japan and UK.

### Policy backdrop

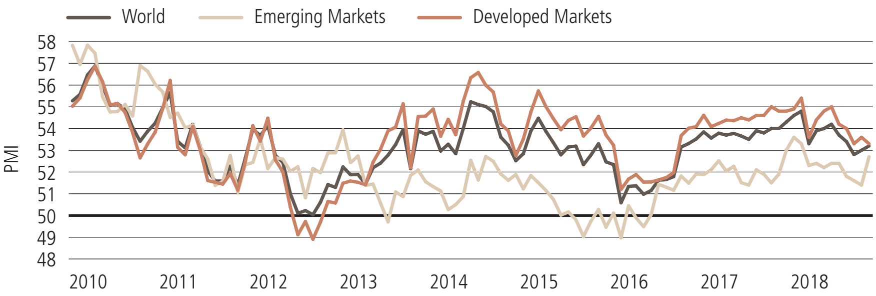
Of course, healthier economies encourage policymakers to remove accommodation. Back in December 2015, investors were concerned given the economic backdrop that the Fed was committing a policy error when it delivered just its first hike in this tightening cycle. Eight additional hikes

**Exhibit 2: 2015-2016 Credit spread and Treasury yield changes vs 2018 (basis points) bps**



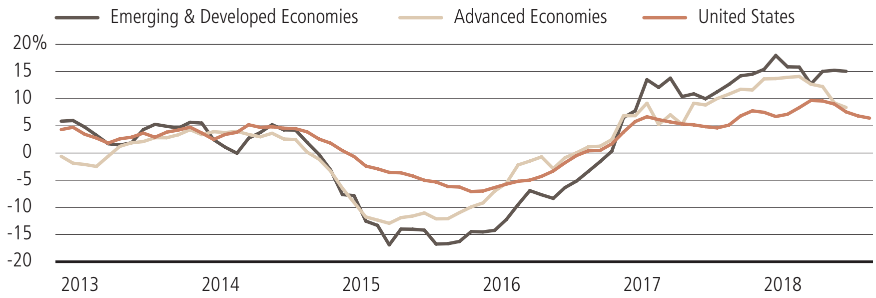

Source: Bloomberg as of December 26, 2018.

**Exhibit 3: Global composite PMIs**




Source: UBS Asset Management, Macrobond, IMF, as of December 26 2018.

**Exhibit 4: Nominal export growth (YoY)**

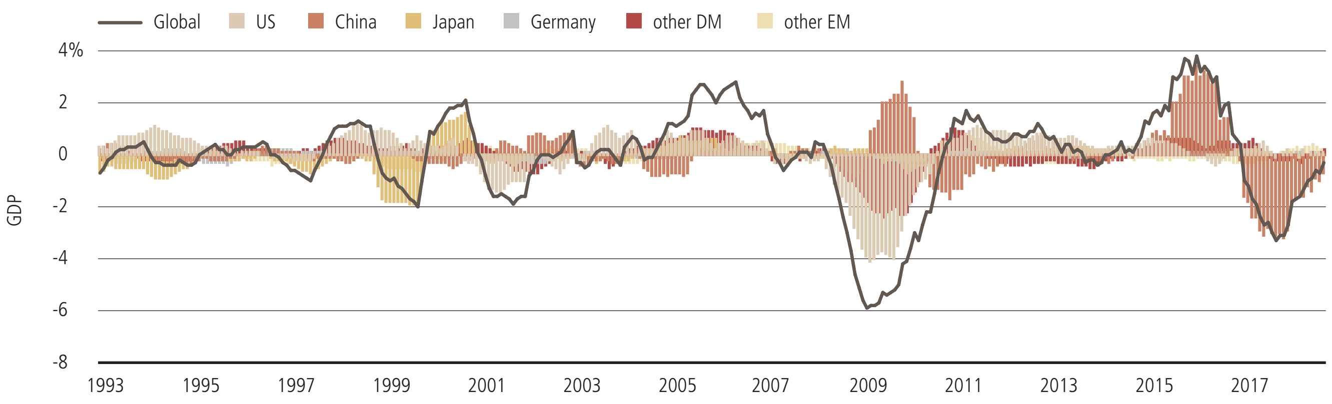



Source: UBS Asset Management, Macrobond as of December 26, 2018.

**Exhibit 5: China nominal GDP (YoY)**


Source: UBS Asset Management, Macrobond as of December 26, 2018.

**Exhibit 6: Contributions to Global Credit Impulse (market GDP weighted)**



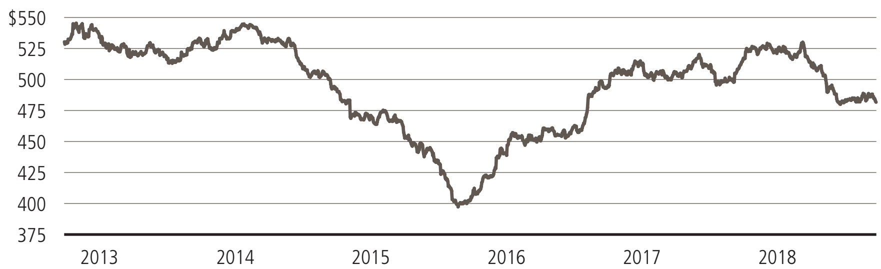

Source: UBS Investment Bank, Haver as of September 2018.

later and the Fed is within the range of its estimates of neutral policy while the yield curve is close to inversion. Once again, some investors are fretting that the Fed has made a policy mistake. With real policy rates still just above zero for an economic outlook that remains generally healthy, we are less concerned about the impact of the Fed's tightening to date on the real economy. But we do acknowledge the effect a higher long-term real discount rate has on equity and credit valuations. Still, given the sharp tightening of financial conditions, cooling of inflation and a more data-dependent Fed that is closer to 'neutral,' we expect that the Fed is likely to do just what it did in early 2016—take a pause to assess the underlying fundamentals of the economy and the effects of its tightening to date. We suspect that much like three years ago, a Fed sending an 'on hold' signal will ease market concerns and lead to a stabilization of risk assets.

The other key policy support in early 2016 came from China, as illustrated in Exhibit 6. After tightening credit in the years following the powerful post-crisis stimulus, China ramped up credit creation throughout 2015, and markets began to gain confidence this would be enough to support local and global economic data in early 2016. This easing set the stage for the accelerating global synchronized growth of 2017, prompting China to reverse course sharply last year in the interests of long-term deleveraging and financial stability. With a slowing economy, China's authorities have once again initiated monetary, fiscal and regulatory easing which should cushion the economy in 2019.

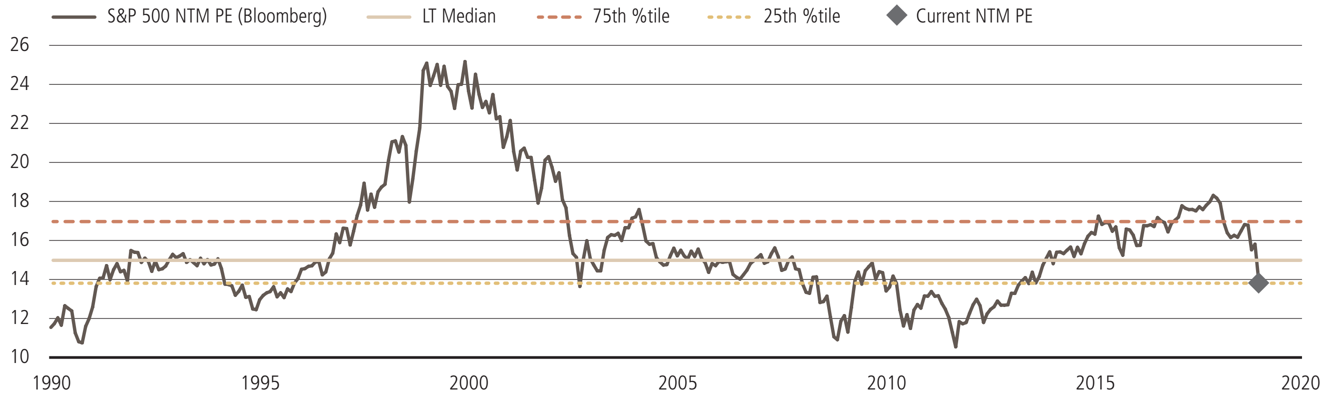
Still, there are reasons to believe the one-two punch of Fed-China policy support may be less powerful and fast-acting this time around compared to 2016. For now, China's policymakers seem intent on avoiding the boom-bust periods of recent years and have maintained a strategic structural goal of de-leveraging. While China's authorities have pulled policy easing levers in a number of areas, the stimulus appears more targeted and piecemeal than in prior reflationary episodes. This is reflected in the CRB's raw industrial commodity index displayed in Exhibit 7. While prices of China's key industrial commodity imports had declined much more sharply several years ago, the rebound was also sharp. 2018's commodity price decline was shallower and seems to have been stabilized by recent policy actions, but a sharp reversal signaling powerful stimulus is absent for now.

**Exhibit 7: CRB Raw Industrials Commodity Index**




Source: Bloomberg as of December 26, 2018.

**Exhibit 8: S&P 500 P/E ratio (Next 12 months)**




Source: Bloomberg, Evercore ISI As of December 26, 2018.

And like China's policymakers, the Fed may find itself more constrained in its ability to take its foot firmly off the brake as it did in 2016. Remember that after hiking in December 2015, the Fed did not hike again until a full year later. While we do expect a pause in the 1st quarter, the reality is that with an unemployment rate below 4% and core inflation near target, we expect that it is more difficult for the Fed to completely abandon its tightening cycle and provide full relief for risk assets. This would particularly be the case if core inflation accelerates this year.

Finally, markets today are grappling with various geopolitical issues that were not major concerns three years ago, most notably the trade and technology tensions between the US and China. The uncertainty on future trade relationships, supply chains and technology regulations are likely to weigh on market multiples and remain an obstacle for quick return to market highs. While market and economic stress may incentivize both Presidents Trump and Xi to reach a deal on tariffs, strategic competition and national security concerns are likely to make regulatory uncertainty an ongoing headwind for years to come.

**Valuation**

One important consideration is that a lot of this negativity is already in the price of major equity indexes. Even assuming a conservative S&P 500 earnings growth estimate of 5% in 2019, the next twelve-month P/E ratio is one standard deviation below its average since 1990, as shown in exhibit 8. This compares to a P/E ratio just at average when markets bottomed in early 2016. That this economic expansion is three years older, discount rates higher and geopolitical tensions stronger will likely limit a return of the multiple to the top of the recent range. But even a move towards early 2016 levels implies healthy returns for equities in 2019.

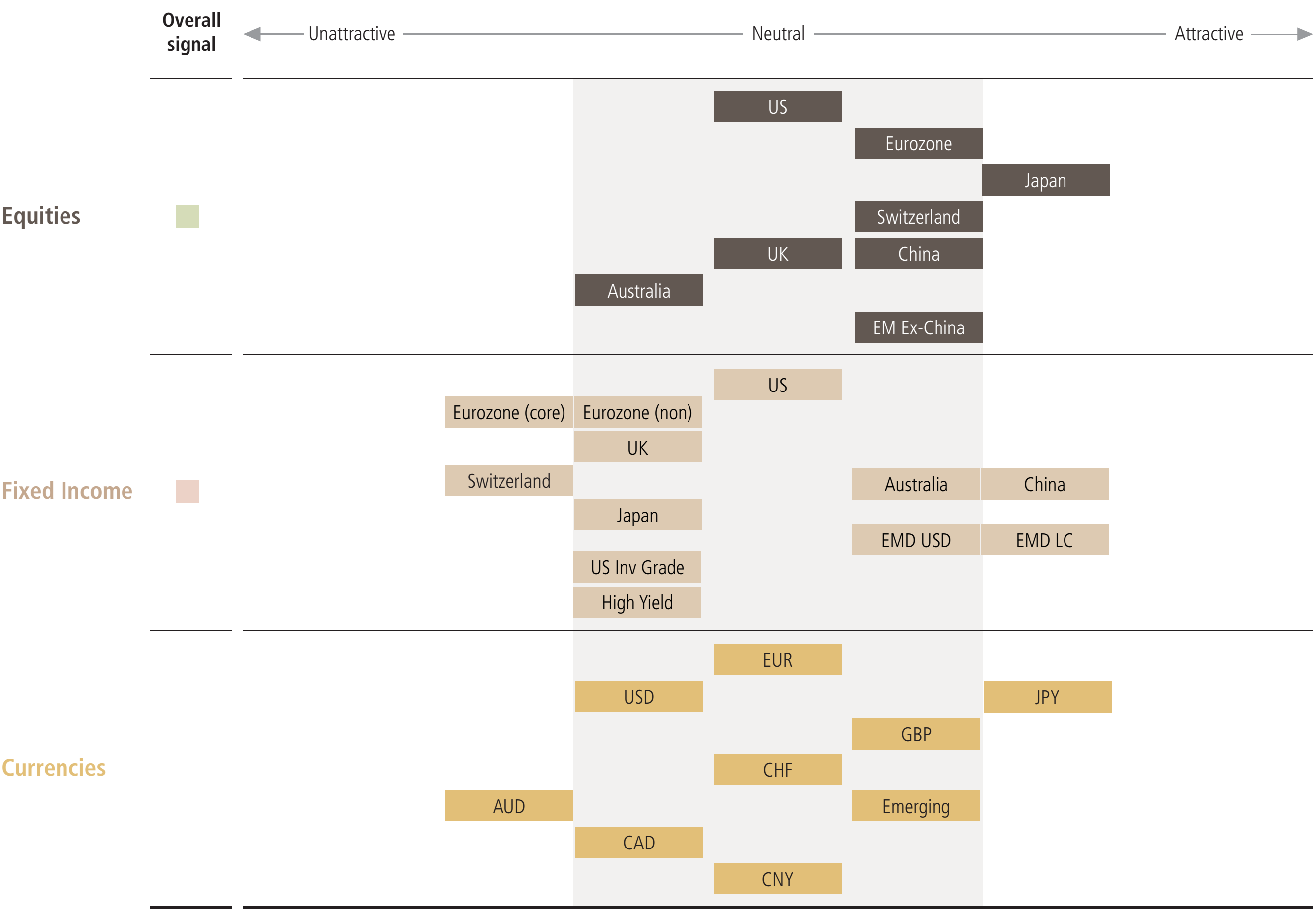
**The bottom line: Asset allocation**

As was the case in early 2016, we expect that the twin policy response of a Fed pause and Chinese stimulus is likely to provide support for risk assets in 1H 2019. But overarching policy objectives and economic conditions facing both sets of policymakers will likely prevent as swift a rebound as that witnessed three years ago. Concerns about cycle length and ongoing geopolitical uncertainties should also keep volatility elevated and the path to higher returns bumpy. The combination of a less hawkish Fed and Chinese stimulus should have clearer effects on the US dollar, which we expect to weaken over the course of 2019. This has made us more constructive on emerging market equities and debt, which we expect to outperform. Indeed, it is notable that EM equities and debt outperformed US equities and credit respectively during the Q4 selloff, suggesting a lot of negative news for EM indexes was already in the price. At current valuations we find global equities attractive, but maintain an underweight in US credit to hedge against further disruption in risk assets.

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 December 31, 2018.




Source: UBS Asset Management Investment Solutions Asset Allocation team as at December 31, 2018. Views are provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change. For illustrative purposes only.

Overall signal =

Positive ◄——► Negative

| Asset Class | Overall signal | UBS Asset Management's viewpoint |
|---|---|---|
| **US Equities** | | – US equities remain supported by solid corporate earnings growth and increasing capital returns to shareholders. But the most recent earnings season exposed vulnerabilities in some momentum sectors and illustrates how difficult a return towards more normal growth expectations can be—especially after a period of exceptionally supportive fiscal and monetary policy. We do not expect current headwinds on the IT sector to abate quickly given the present political and regulatory environment. While the recent de-rating leaves US equity valuations below long-term averages, we continue to believe that the case for equities outside of the US is stronger. |
| **Global (Ex-US) Equities** | | – In Europe, the deal between the Italian government and the European Commission on the former's budget is a short-term positive, but with the likelihood of an extreme Brexit outcome increasing, significant geopolitical uncertainties persist. Together with the current headwinds on global trade this is likely to hamper the near term performance of European equities. However, our longer-term base case remains positive, supported by solid domestic demand dynamics, attractive valuations and by a likely stabilization of global economic conditions towards the second half of 2019.<br>– We remain constructive on Japanese equities despite the near term headwinds from weakening global growth. We believe that diminished political uncertainties and on-going structural reforms are supportive of higher price multiples while a solid underlying domestic economy suggests the outlook for profits growth is stronger than markets are currently discounting. |
| **Emerging Markets (EM) Equities including China** | | – Emerging market equities have recently outperformed despite continued USD strength and a further slowdown in global growth. Part of the outperformance comes from the expectation of a widening EM-DM growth differential. In aggregate fundamental conditions in EM remain relatively robust but we remain wary of the impact of sharply tighter US financial conditions and higher interest rates in several Emerging economies.<br>– We remain broadly positive on China in the expectation of further measures to cushion the domestic growth slowdown. Any broadening of the current trade stand-off with the US is likely to hamper Chinese growth, but we believe that a gradual economic slowdown is already priced in and the Chinese authorities have already shown themselves willing to provide monetary, fiscal and regulatory support 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** | | – After the recent downward re-pricing of US rate expectations, 10yr nominal US Treasury yields are close to the low end of the range of our estimate of fair value. Nonetheless, US nominal yields look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pick-up in inflation or term premium, we expect that yields are likely to remain range bound. Our overall assessment is neutral. |
| **Global (Ex-US) Bonds** | | – In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB has committed to low rates into 2019, so we see limited opportunity in Europe. Brexit is probably negative for UK gilts in the case of both a hard and soft Brexit. In a hard Brexit scenario, gilt yields are likely to fall first on lower growth expectations before rising on higher inflation risks and a higher credit risk premium. Should the current deal pass through parliament, we would expect UK 10yr yields to rise immediately due to improved growth prospects.<br>– 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.<br>– Elsewhere we are more positive on Australian duration on a relative basis. We see the Reserve Bank of Australia taking a cautious approach to policy given elevated household leverage and slow inflation. |
| **Investment Grade (IG) Corporate Debt** | | – Fed tightening, growth concerns and geopolitical turmoil have spilled over into the credit markets, causing IG spreads to widen 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** | | – Current default rates in High Yield are very low by historical standards. Given the still relatively positive economic backdrop, we do not expect a material pick-up in US defaults in the near-term. However, after the significant recent sell-off, spreads have now widened to a point where we do not see a strong case in either direction. |
| **Emerging Markets Debt**<br>US dollar<br>Local currency | | – Spreads on EM debt relative to US treasuries widened substantially in 2018 in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates. However, in recent weeks EM local currency bond yields have rallied both in absolute terms and relative to the US yields while EM hard currency bond yields have continued to sell off. We believe that this reflects wider investor expectations for a less aggressive Fed, less aggressive US trade policy, and/or more aggressive China stimulus. We upgrade EM local currency bonds given their attractive valuations. |
| **Chinese Bonds** | | – Chinese 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. We expect that slowing economic growth and inclusion to the Bloomberg Barclays Global Aggregate index next year should continue to push yields down during the next 3-12 months. |

Source: UBS Asset Management. As of December 31, 2018.

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