UBS-SFA Investment Outlook

August 2017

Finally, it is summer time without the blues

Global economic growth: So far so good
With the summer in full swing it seems that for the first time in years we don't have to worry about summertime blues for the global economy. In recent years, most economists have had a regular pattern of forecasting about 3.5% global growth at the start of the year, only to lower it to about 2.5% to 3% by mid-year. This year we are happy to report no net downward revision. Growth has been a bit stronger than expected in most advanced economies (AE), but weaker than expected in emerging markets (EM).

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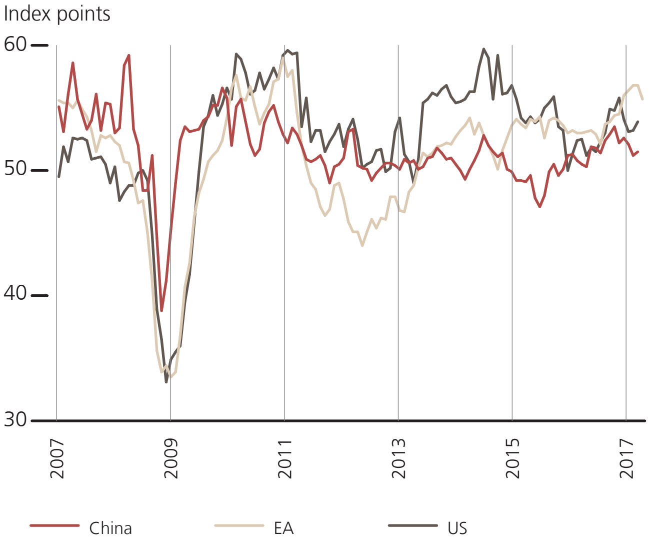
In our view, a modest pick-up in global growth started about a year ago when a number of headwinds faded: reduced fiscal austerity, less uncertainty from sharp commodity price and exchange rate movements, and a delayed adjustment to the slowdown in China. We continue to expect modestly above-trend growth over the next twelve months as well.

PMI indices



Source: Bloomberg, UBS-SFA

A few idiosyncratic stories stand out. Political turmoil is most likely leading to lower Brazilian economic growth, with GDP stagnating at best for this year and returning to only modest GDP expansion of around 1.5% next year. This is remarkably weak for an economy that is "recovering" from a major recession. Another interesting case is the UK. The economy initially weathered the Brexit shock but is now starting to weaken: a currency-induced jump in inflation combined with persistently soft wage growth has caused real incomes to drop, cutting into growth. The road could get even rockier as the deadline for Brexit approaches and businesses adopt a "wait and see" approach to new commitments. On a more optimistic note, the commitment to reflation in Japan continues to encourage us.

Even though we see pockets of strength (notably in the euro area (EA)) and our overall projections remain on track, we suspect that the world economy is approaching the global cyclical peak, after reaching the first period of synchronized growth. This peak is most likely to occur in the course of 2018. Global manufacturing PMIs have started to flatten (from 53 in February to 52.6 in May). The acceleration of growth in industrial activity appears to be stopping. Global real growth in industrial production was still healthy at roughly 4% in May, a near 3-year high as a result of synchronized growth. Global trade growth appears to be moderating, admittedly from what are heady levels by recent historical standards. There are some signs that Chinese activity is also moderating, mostly due to regulatory tightening.

Monetary policy and inflation – Reflation under attack

We have previously defined 'reflation' as a pick-up in nominal GDP growth, and our expectations for 2017 nominal GDP growth remain on track, too. We currently expect global nominal GDP growth of close to 5.5% in 2017 (the highest since 2011). In our view the downside risks to inflation and to our inflation projections are rising. A comparison of the G5 core inflation against the policy target also demonstrates that financial markets appear to be increasingly skeptical about the near-term prospects for higher inflation.

One of the striking things about the recent period is that core inflation is no closer to target than it was five years ago. In other words, the return to target remains a forecast, not a reality. The drivers of lower-than-expected inflation are familiar:

- Energy prices are less than anticipated. End-2017 forwards for oil are now 10% lower than they were at the beginning of the year. Spot Brent has fallen from its May 2017 peak of $54 per barrel to $46 per barrel, most recently due to higher-than-expected supply.
- The average AE unemployment rate has fallen to 5.9%, yet across AEs wage growth remains modest and most recent wage data do not suggest rising wage pressure, including in the US. Potential explanations for continued sluggish wage growth abound, including larger-than-expected labor market slack, lower bargaining power of workers and a greater focus of workers on non-wage benefits, according to the Employment Outlook of the OECD released in spring 2017. Meanwhile, product prices may also respond only slowly and gradually to diminishing slack or wage pressures because, for instance, more intensive competition may lead firms to absorb rising unit labor costs partly through lower margins.
- Softer inflation expectations. One factor in the sluggish response of wages and prices may be that inflation expectations have become more backward-looking, as recently noted by several central banks.

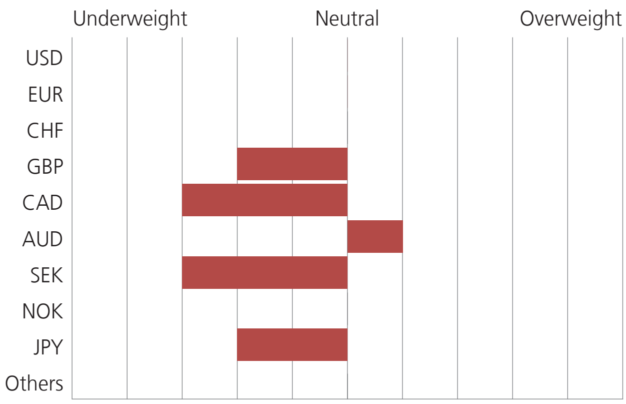
Investment conclusions

Global foreign exchange

The USD: Range-bound despite the Fed bias

We stick to our projection for the USD, which we still see as range-bound and constrained by the gradual normalization measures of the Fed's monetary policy and the uncertainty about the future stance of monetary policy in other AE economies, notably the ECB. As long as US real yields do not rise significantly due to persistently higher economic growth in the US, we see no substantial trigger for the USD to appreciate. Such a trigger would be a significant fiscal stimulus package initiated by the US administration, an acceleration of global trade or faster and stronger rate adjustments by the US central bank. But such events are less likely to happen soon. Hence, further USD strength remains a distant prospect. Do we foresee forces that may weaken the EUR against the USD? The ECB has clarified that the economic recovery in EA has broadened and deepened. Economic growth can reach 2% in 2017 and inflation is not falling anymore. Under this scenario, we don't expect the ECB to lift the degree of accommodation. Furthermore, the likelihood has grown that the current growth of the ECB's balance sheet may slow in the near future. Whether we already see an exit from the current ECB's bond purchase program depends on whether EA inflation is expected to move towards the 2% policy target in a reasonable timeframe.

Currency allocation preferences (six months)



Source: UBS-SFA

The results of the UK election simultaneously trimmed the likelihood of more positive long-run Brexit outcomes, while raising the risks of a 'crash out' from the EU with no deal. The UK's negotiating position vis-à-vis the EU has deteriorated as domestic politics may have constrained the set of Pareto-improving Brexit options; meanwhile, the government's minority status raises the risk that it cannot pass any deal negotiated with the EU. Balancing these potential short- and long-term outcomes, we estimate a lower path for the GBP than previously expected.

The AUD has underperformed its commodity peers, as we expected. However, it is close to year-highs versus the USD, supported by a strong run of domestic data, especially employment, as well as improving China sentiment (including a surprise jump in the manufacturing PMI). From the RBA's perspective, this is unlikely to present a concern so far because the trade-weighted index remains within year-highs, despite some strengthening in June. From an external perspective, we maintain our outlook for a growth stabilization in China. We have previously shown that China's imports from Australia tend to be closely correlated with steel production rates, with the latter leading by one quarter. We maintain our view that the AUD will stay the course as an alternative for yield enhancement in the current and foreseeable low-rate environment.

Global bonds overview

Higher government bond yields are finally a sign of economic health

Since the end of June, government bonds have experienced rising yields, creating concerns across asset markets that have resulted in rising volatility and outflows from other assets and emerging markets. The German government bond market has been the epicenter of the move in yields, with the sell-off triggered by a shift in ECB rhetoric that has changed the dynamic of forward guidance. In the aftermath of Draghi's speech indicating that some tapering may already be in the cards for the ECB, German government bonds lost around 25 basis points. The respective yield of US government bonds rose by about 15 basis points. All in all, the recent movement in yields has resulted in steeper yield curves.

We have already mentioned that a steepening yield curve is a reflection of improving economic conditions. Higher growth is associated with higher inflation and hence – in reaction to the acceleration of economic growth and inflation rates – higher central bank rates. As today's long-term bond yields are the consequence of future short-term rates, higher expected economic growth tomorrow determines today's long-term yields. However, central banks in AE don't get tired of emphasizing that although inflation is moving towards the inflation targets, they still need evidence that inflation is reaching the policy objective. If inflation fails to achieve the policy target, yields could come down again. We therefore aim to avoid negative yields by maintaining a neutral duration stance for our USD-based portfolios and a moderately long duration stance for CHF and EUR-denominated portfolios.

Investment and non-investment grade corporate bonds continued to deliver solid returns even as government bonds sold off. Over the past years, spreads continuously tightened and have reached stretched valuations that can be justified only by sound and stable credit quality. Although the economic upswing may accelerate and boost earnings growth, further spread compression and capital appreciation appear limited. The spread for EUR-denominated non-investment grade corporate debt now stands at 288 basis points over government bonds, implying that the current spread is around 80 basis points below one standard deviation. We are continuously monitoring the further development.

Global equity overview

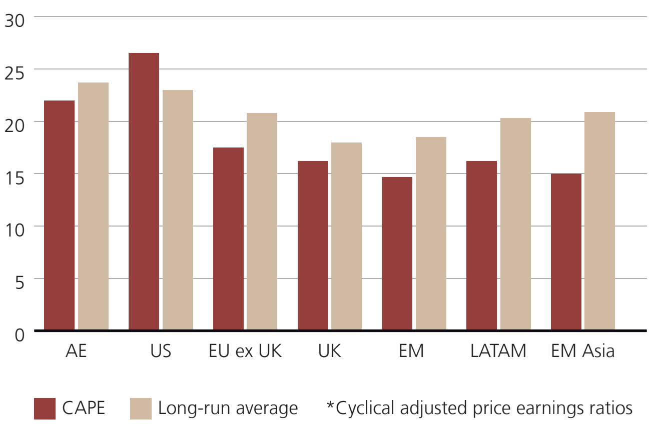
Rising yields a threat for synchronized growth = synchronized EPS growth?

Investors are worried about higher real yields following recent hawkish central bank rhetoric in the US and EA. While the Fed let investors know that equity prices were high against standard valuation measures, the ECB suspects that the current stance of its monetary policy is becoming too easy in the face of the current economic recovery in EA. Indeed, financial conditions have continued to improve. This led investors to believe that central banks are now buying the Bank of International Settlement's thesis that they need to control not just price, but also asset-price inflation. In other words, asset markets may be inflated by easy money, implying that investors expect central banks to remain biased towards tightening until asset markets turn lower. However, a significant correction in the equity and credit markets would imply a strong deterioration of financial conditions and would defer any liquidity withdrawal by central banks into the future. It seems that market volatility and the tightening of financial conditions are constraining the central bank's policy stance. We therefore remain constructive on AE equities. The current synchronized global business cycle is expected to last into 2018, prompting earnings growth. Consensus top-down projections stand at around 10%, while bottom-up analysts estimate that EPS may grow at a pace of approximately 15%.

The MSCI AC World benchmark currently trades on a trailing P/E ratio of 20x, above the long-run median of 17x and well up from the 12x low reached in the EA crisis. It has fallen recently due to the earnings rebound. Within regions, the UK looks most expensive due to weak trailing EPS and the post-Brexit rally. Sustained market performance means that the US looks stretched, too.

Trailing P/Es provided few sell signals in 2007, making investors suspicious of their worth. Instead, many now prefer to look at valuations based on average or trend EPS. These measures make markets look more expensive when profits are high and cheaper when they are low. We watch the cyclically adjusted P/E (CAPE) that compares current share prices to the 10-year average EPS. The global CAPE is now 24x, slightly above the long-term median of 23x. The US is most expensive on this measure (28x). Japan ranks second at 26x. UK and EM equities look cheapest.

World equity valuation*



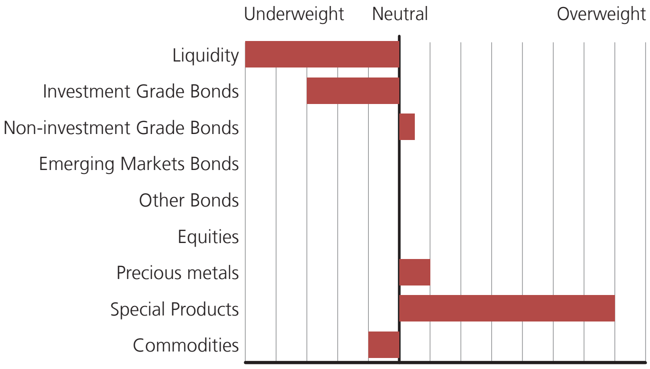
Source: Datastream, UBS-SFA

Although absolute valuations are starting to look stretched, global equities still seem to be a decent value compared to fixed income. MSCI World offers a yield (2.4%) well above that on the global government bond index (1.0%). Equity markets yield significantly more than bonds in all the major AE economies outside the US. Global income investors should continue to be drawn to Australian equities, although the biggest premiums relative to local bonds are to be found in Europe.

The biggest risk to our view remains a significant global slowdown. If that occurs, dividend yields may not provide downside support and the EPS growth recovery would falter. Our market view would be too optimistic and our regional recommendations would need to be more defensive.

Another threat to risk assets might come from tighter monetary policy. Synchronized tightening will reduce the securities purchases by global central banks from $2 trillion (on a 12m rolling basis) to around $1 trillion. There is a close relationship between central bank purchases and asset performance. If central banks shrink liquidity together, spreads could rise significantly, with a nasty spillover effect on equities.

Asset allocation preferences (six months)



Source: UBS-SFA

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