UBS-SFA Investment Outlook

Will higher oil prices derail economic growth?

Recent economic data releases – soft and hard data – suggest that the pace of global economic expansion has slowed and become less synchronized, due mainly to a moderation in business sentiment. The decline in business sentiment, which may be due to trade tensions, more volatile financial conditions and a rise in oil prices, initially weighed more on developed markets (DM). However, the recent appreciation of the USD by around 5% in nominal terms since mid-April and the continued rise in mainly US interest rates of approximately 0.5 percentage points have now engulfed emerging markets (EM) as well, even though the spill-backs from EM to DM appear to be limited for now.

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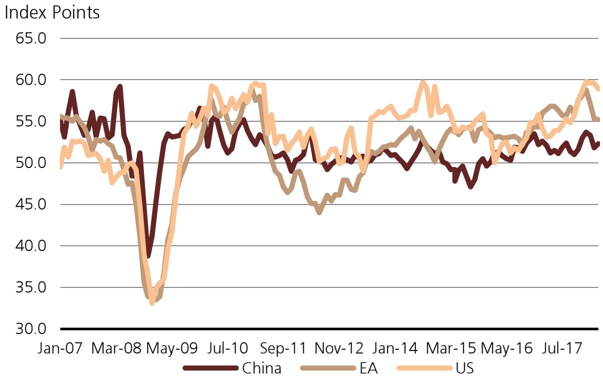
Global growth slows down, but remains above trend

Some of the drags are likely to be temporary, such as the payback from unusually fast growth in the second half of 2017, when the economy in Euro Area (EA) expanded by around 3%, the US economy by more than 3%, and the emerging markets, thanks to brisk growth in world trade, by about 4.5%. The adverse weather impacts across Western Europe, the US and Japan have also taken their temporary toll on economic momentum, but should spur economic growth in the second quarter due to strong pent-up demand.

While the positive effects of the US tax reform should ramp up over the course of this year, clouded business sentiment due to trade tensions which may prove hard to resolve as well as some tightening in financial conditions due to a less accommodative monetary policy in DM and the rise in oil prices, are likely to have a dampening impact on global growth.

Purchasing manager indices (PMI): Stabilizing



Source: Bloomberg Finance L.P., UBS-SFA, as of May 2018

Oil – A global macro shock?

Rising oil prices are a strong source of differentiation across economies; oil exporters may benefit and net oil importers will have to bear the burden of a higher oil bill. In nominal USD terms, oil prices hit nearly 80 USD per barrel, the highest level since late 2014 – an almost 50% rise since summer last year.

Brent oil price: Rising!

Source: Bloomberg Finance L.P., UBS-SFA, as of 25.05.2018

A minor increase compared to the oil price shocks of the 1970s

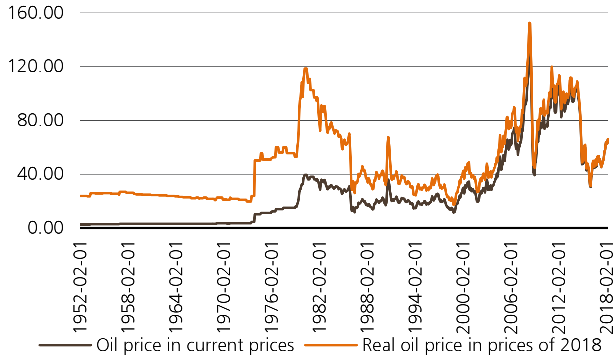
As a consequence of oil prices creeping higher on a combination of global demand strength, OPEC restraint, geopolitical and sanctions-related uncertainty and slow oil supply growth (US shale production growth cannot keep pace with rising demand, and inventories have fallen below the five-year average), will global GDP growth decelerate and inflation accelerate significantly? Before investigating the sensitivity of higher oil prices to growth and inflation, it is worth noting that the current oil price (Brent) of 80 USD per barrel means something different than it did for an earlier generation. In order to evaluate this statement, we define historical oil prices in constant 2018 USD prices. This allows us to equalize the magnitude of the oil price shocks and then look at the year-over-year spikes.

Empty freeway in Germany during the oil crisis in 1973

Source: picture-alliance/dpa

The surge in oil prices in the early 1970s reached more than 180% in nominal terms and approximately 160% in real terms, resulting into an abrupt end to the global economic upswing. Compared to the oil price shocks that led to recessions in the past, today's oil price increase is around eight times smaller than the oil price acceleration of the 1970s and will thus have a less severe impact on economic growth and inflation.

Real oil price for WTI per barrel

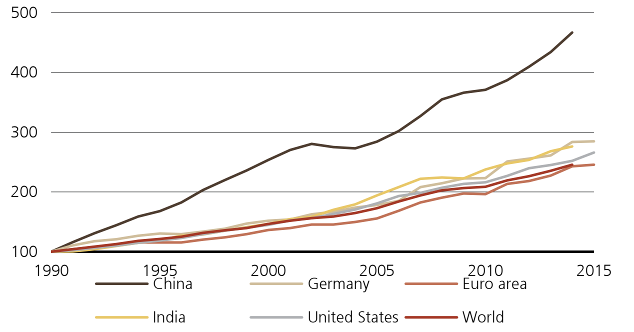


Source: Federal Reserve Bank of New York, UBS-SFA

Energy efficiency has increased remarkably

A second factor to take into account is the energy sensitivity of the production value chain. This measures how many units of energy (fuel) are needed to produce one unit of GDP. According to the World Bank, energy efficiency has increased substantially. In DM, for instance in the USA and the EA, energy efficiency has more than doubled since the early 1990s, while China's energy efficiency has even quintupled. China is now able to produce around 6 units of GDP with one unit of energy. In the early 1990, China needed one unit of energy to create 1.3 units of GDP. This huge gain in energy efficiency also mitigates the negative impact of economic growth and inflation for net oil importers, especially in DM.

Increase of the energy efficiency of selected economies (in index points)

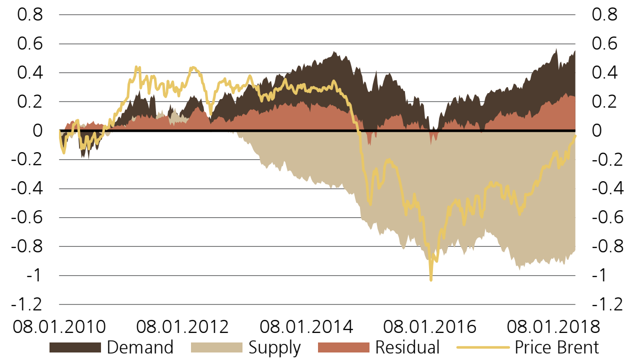


Source: World Bank, UBS-SFA

Demand or supply induced?

When evaluating the consequences of higher or even soaring oil prices on growth and inflation, it is of paramount importance to determine whether the price shock has been generated by demand or supply-side factors. If fast-growing demand causes oil prices to increase, higher oil prices cannot fully absorb the growth stimulus that gave rise to the oil price shock (it would be like saying that no one is going to the shopping mall because it is too crowded). Supply-side shocks can, unlike a demand-side shock, cause GDP growth to fall below the rate of growth reached before the shock occurred. According to the Federal Reserve Bank of New York, the plummeting oil price between late 2014 and early 2016 is explained by a combination of excess supply and falling demand, whereas the recovery in oil prices is mostly attributable to rising demand as shown in the following chart.

Demand and supply side factors and the change in oil prices (in %)



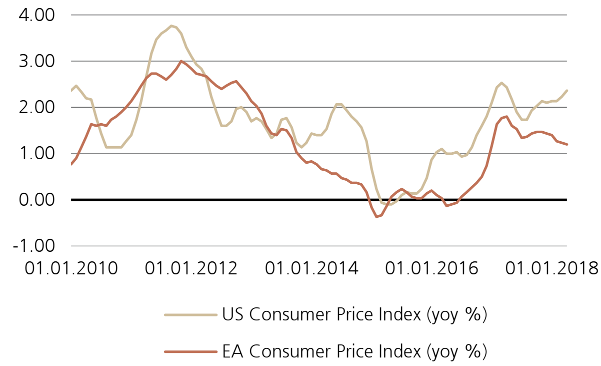
Source: Federal Reserve Bank New York, UBS-SFA

However, since the beginning of this year, demand-side factors are assessed by the Federal Reserve Bank of New York as neutral for the movement of the oil price, while supply-side and unexplained residual factors are causal for the rise in the oil price. Oil price increases resulting from supply-side bottlenecks could generate negative consequences for growth and inflation and have an asymmetric effect on growth and inflation for oil producers and oil consumers. Whether the net effect on growth is negative or positive depends on the price sensitivity of private consumption and the impact of the oil price rise on business investment. If private consumption does not fall greatly in reaction to lower real income, and business investment in the oil sector starts to accelerate again, the net effect may be positive. According to the Organization for Economic Co-operation and Development (OECD), for the US, the negative effects on consumption and the positive effects on business investments roughly cancel each other out, while a permanent increase in the oil price of 10 USD could reduce OECD economic activity by around 0.2 percentage points over two years. As we do not expect oil prices to accelerate further, given the ability of the US energy sector to rapidly increase the supply of oil in the light of higher prices, we are sticking to our base case scenario of healthy prospects for the world economy carried by private consumption, business investments and solid global trade. Nevertheless we acknowledge that less synchronized growth implies softer economic expansion. However, a recession in the foreseeable future is relatively unlikely in our view.

Inflation and monetary policy – Inflation subdued and central banks cautious in DM

For now, underlying inflation pressures remain contained in DM, at least ahead of any pass-through of higher oil prices. Average headline inflation in DM ticked down to 1.8% in April from 1.9% in March, but on the longer-term moving average basis, so-called inflation momentum slowed to a seven- month low of 1.8% from 2.8% in March, as inflation in April surprised to the downside in the Eurozone, Japan and the US. Momentum in DM core inflation also fell slightly to 1.8% from 2.0% in March, but remains at the higher end of the range in recent years, with momentum core inflation in the US at 2.6% and the difference between US and DM-ex-US inflation still at recent highs. Looking ahead, headline inflation rates are bound to be boosted by the rise in energy prices, but fading positive base effects on US inflation will likely limit the increase in DM inflation in the months ahead.

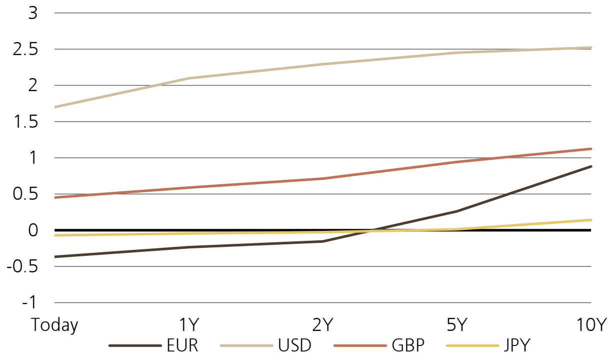
Consumer price inflation* in the US and EA (in %)



Source: Bloomberg Finance, L.P., UBS-SFA, *12 months moving average

Downside risks to growth and subdued inflation have induced several central banks in DM to remain cautious or indeed become more so, including in New Zealand, Sweden and in Japan, where the Bank of Japan removed the explicit reference to when 2% inflation is likely to be met (and seven out of nine board members saw inflation risks as skewed toward the downside). Correspondingly, the market pricing of DM policy rate increases for the remainder of 2018 has come down slightly in Australia, New Zealand and the UK over the last month, while markets continue to price few risks of rate hikes in the Eurozone or Japan.

Interest rate expectations* for selected currencies (in %)



Source: Bloomberg Finance L.P., UBS-SFA,
*based on the Overnight Index Swap (OIS) for the respective currency

The main exception is the US where the Fed continues to signal its intent to gradually normalize the rise in policy rates and Chair Powell recently noted that EM would likely be able to deal with such a steady rise in US interest rates. Consequently, the projected differential between US and non-US DM policy rates by market participants continues to grow (currently at 160 basis points, the largest since December 2007). We expect that this spread in central bank rates between the US and the rest of DM could go as high as 200 basis points by end-2018, while market prices project it to rise to around 220bp, reflecting the pass-through of higher oil prices on headline inflation over the coming months. Nevertheless, even though energy prices will push up at least headline inflation in the months ahead, we think that central banks would only react to evidence that higher oil prices are having second-round effects.

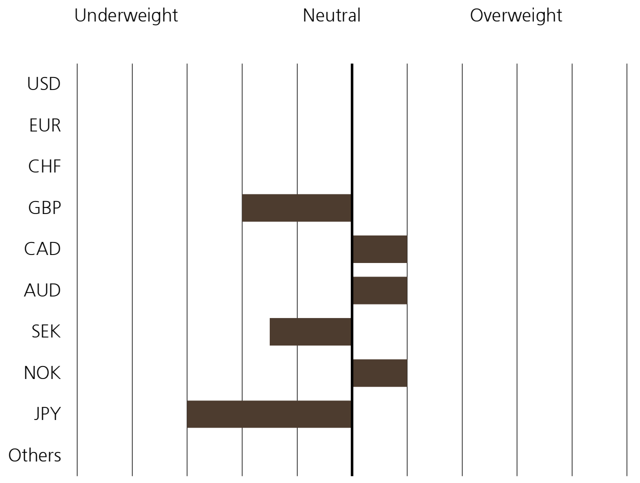
Investment conclusions

Global foreign exchange – Italy moves into uncharted territory and the EUR?

The failure to form a government in Italy and the prospect of a snap election in late summer or early autumn have prompted significant dislocation in the European financial markets. While the softening of economic momentum has been responsible for the EUR's setback from 1.24 to 1.18 against the USD, political uncertainty about the future stance of an Italian government led the EUR to slide to slightly above 1.15 against the USD. Other warning bells have also begun to sound: the yield of the 2-year Italian government bond rose from around -0.2% to over 0.8% in a few days, while the spread between Italian and the German 10-year government bonds widened to more than 2.5%, the highest risk premium for Italian government debt in the aftermath of the EUR sovereign crisis. However, although Italy is moving into uncharted territory, given the heightened uncertainty about its political future, the stance of fiscal discipline going forward and Italy's ambivalent attitude with respect to its continued membership of the Euro Area, a real crisis such as a market collapse or even the insolvency of the Italian government is not our base scenario. Italy is still running a primary surplus (tax revenues greater than public spending excluding interest rate payment on outstanding debt) of around 1.6%, the second highest surplus in EA after Germany. The sell-off of Italian assets and the spillover into a risk-off attitude with a broad-based selling of equities appear to be overdone and can only be explained by the expectations of an Italian default and concerns over a potential Italian exit from EA. Although the rhetoric of the leading political parties - M5S and Lega - appears to be aggressively Eurosceptic, the leaders of both M5S and Lega confirmed they want the country to stay in the euro. An exit was not part of their respective or joint policy programs. Unlike the UK's decision to exit the European Union, with the UK having its own currency, Italy leaving the currency union with a re-introduction of the Italian lira would result in a severe bank run, with the risk the Italian banking sector collapsing and an unknown outcome for economic growth and unemployment. This jump in risk aversion has intensified the demand for USD and USD-denominated assets. Since its local trough in mid-February, the US dollar has appreciated by about 6.1% against the euro, around 6% for the DXY index and approximately 3% for the broad trade-weighted index. The EUR now stands at around 1.17 against the USD. As long as the Italian situation remains so nebulous, we do not expect a fast lift of the EUR into our forecast range of 1.2 to 1.28 against the USD, especially as market participants continue to doubt whether the ECB will reduce or even terminate its asset purchase program in autumn 2018.

Both the CAD and the NOK have started to appreciate with the strong rise in the oil price. As long as the oil price remains at its current levels of around 75 USD for Brent, we continue to maintain our moderate overweight allocation to these diversification currencies. Economic momentum has improved for both economies, leading market participants to renew their expectations that higher central bank rates in both countries will provide additional support for the CAD and the NOK, especially against the EUR and CHF.

Currency allocation preferences (six months)



Source: UBS-SFA, May 2018

One downside of the current USD strength is its impact on emerging market currencies, particularly in an environment of rising global risk aversion. USD dollar strength and appreciation (and their combination with rising interest rates) would be expected to weigh on countries with large USD-denominated debts and current account deficits and therefore imply greater differentiation across EMs. Two economies that suffer from high (and rising) dollar debt and high current account deficits are Argentina and Turkey. However, the link between dollar strength and global risk aversion may have marginally weakened in recent years since (1) EM's net external balance sheets have strengthened on average, as EM current account deficits have fallen and measures of FX reserve coverage risen and (2) the USD's safe haven status may be more in question than in the past. This gives us confidence to maintain our exposure to local currency emerging market bonds.

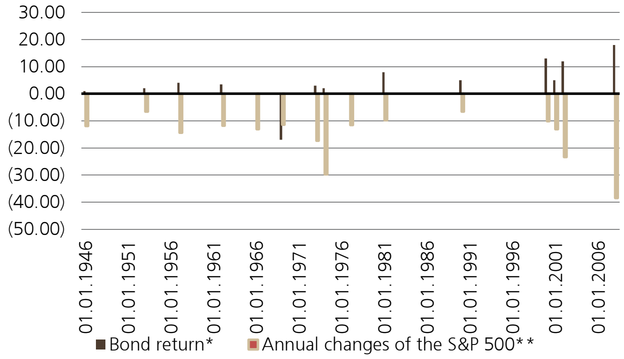
Global bonds – Bonds hedge growth deceleration but not inflation momentum!

The flattening of the US yield curve, which was analyzed in great detail in last month's edition, has investors scratching their heads and seeking historical parallels. One episode which seems to be very similar is the 1969 / 1970 period and the subsequent recession. The late sixties also saw late-cycle fiscal stimulus contributing to runaway inflation, with the Fed inverting the yield curve by raising rates and creating a recession. However, this period was special as it combined a recession with a structural rise in inflation expectations, challenging the ability of bonds to hedge against a downturn. What are the lessons for investors today? And the key question: will bonds work as a cushion in the next recession?

The correlation between bond and equity returns has waxed and waned throughout history, but has been mostly negative for the new millennium. However, the relationship has become more unstable in DM in the aftermath of the Great Recession of 2008. In 2013, due to Bernanke's "taper tantrum" speech, both bonds and equities were sold off in response to the Fed's hints about an end to quantitative easing. This period also includes the German government bond yield spike in 2015 and the recent equity market sell-off, when bond yields rose. During these episodes, a traditional bond allocation would have exacerbated portfolio risks, rather than offering a buffer. This is a result of the ultra-low interest rate and quantitative easing (QE) policies that have spread low interest rates across the curve.

History provides a guide: it is rare to see negative returns in both stocks and bonds in the same year. Of the 15 years since World War II with negative equity returns, U.S. 10-year Treasuries generated positive returns in all but one. Bonds hedge growth, not inflation risks. Bonds tend to perform well in recessions as they are deflationary, with falling activity and prices (or expectations thereof).

Bonds hedges growth – equities stress



Source: Bloomberg Finance L.P. UBS-SFA as of 2008
*Annual percentage change of the 10 year US government bond times duration plus average coupon
**negative annual percentage change of the US S&P 500 greater than 5%.

The 1969-70 episode stands out: excessively loose monetary policy coupled with late-cycle fiscal stimulus led to a decade of de-anchored inflation expectations. As growth faltered in 1969, bonds suffered losses even as stocks stumbled. And in the 1970s, bond prices fell in several years of negative equity returns (though high starting yields kept total returns positive). The overall lesson: Bonds are a good offset to stocks when it matters most, unless the equity market selloff is triggered by a Fed trying to quell runaway inflation. Put differently, bonds cushion against growth risks but not inflation risks.

Sustained global expansion with inflation slowly moving back toward trend provides a positive backdrop for credit in the form of low default rates and stable default expectations. But valuations reflect this dynamic, as evidenced by tight spreads across both high yield and investment grade. Credit spreads have historically tightened through economic expansions. Once the cycle matures and economic spare capacity has been used up, they tend to trough, as our analysis of past cycles shows. This implies less upside potential at this stage of the cycle.

The extended cycle in the US means investors may expect coupon income but with lower total returns than in recent years. Spreads are compressed both in absolute terms and across the quality spectrum. Our outlook for policy normalization and further Fed rate increases this year leads us to prefer market neutral duration and investment grade bonds over non-investment grade debt as a built-in buffer against rising rates.

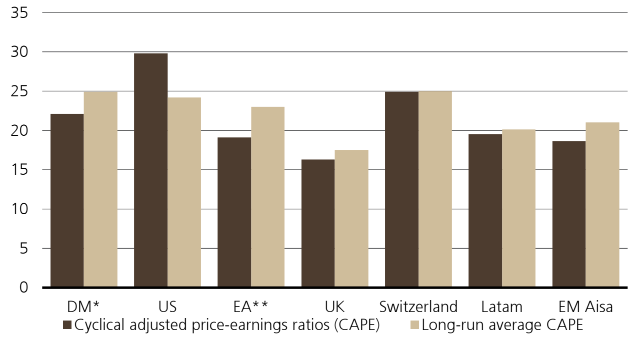
In Europe, ongoing ECB purchases of corporate bonds leave spreads tight, not unlike in the U.S. But the impact down the capital structure limits the attractiveness of subordinated yields, which stand below equity dividend yields. We see better a risk/reward from owning equities.

Global equities – Maintain overweight allocation and stay invested!

Despite the specter in Italy and somewhat softer economic growth, we still maintain our preference for US and EA equities. We are therefore keeping our overweight allocation to global equities. Nevertheless we are carefully monitoring the developments in Italy. Any aggravation in terms of fiscal discipline deteriorating, or evidence popping up that Italy will leave the currency union, will trigger an adjustment of our tactical asset allocation. So far, we remain confident that our base case scenario of sustained and synchronized growth is still valid, supported by (1) accommodative financial conditions globally, (2) strong world trade, (3) easing fiscal policy in DM, (4) less regulation at least in the US and, last but not least, (5) sound earnings growth.

Our preference is slightly tilted toward EA equities for the following reasons. First of all, the EA cycle is much less mature than in other regions. To put it more simply, Europe is the only major economy where the unemployment rate is closer to its long-run average than it is to closer to trough levels. Secondly, there is potentially more upside to European profitability than elsewhere if the economic cycle continues. Europe is the only region where earnings-per-share (EPS) is not close to an all-time high and currently is 20% lower than a decade ago. Thirdly, The ECB lags behind most other central banks when it comes to starting to normalize/tighten monetary policy, with the market not pricing in the first rate hike until mid-2019. When we compare the current gap between nominal GDP growth and bond yields, this suggests that the ECB is arguably running the most dovish monetary policy setting of any central bank. Furthermore, in absolute terms, EA equity valuations do not appear onerous to us, with valuation metrics only half a turn above their 30-year average at 14.1x and their trailing dividend yield slightly above their long-run average. In relative terms Europe looks attractively valued to us. Although US equities are less appealingly valued, they will benefit from the US tax reform which is boosting retained earnings and providing an unabated solid outlook for the US economy. Thus, we are keeping the overweight allocation to US equities. Given the elevated uncertainties with respect to Brexit, we remain cautious about UK equities and are keeping the underweight allocation.

World equity valuation



Source: Datastream, UBS-SFA, *Developed Markets **Euro area, as end of May