UBS-SFA Investment Outlook

Economic continuity, but a shot across the bow on global trade from Washington

The US administration in the past month has started the process of retaliating against alleged unfair Chinese trade practices by announcing the imposition of tariffs on up to USD 60 billion in Chinese imports to the United States, as well as a host of new measures that will be forthcoming to handle both inbound and outbound investment between the two countries. This led to a significant repricing of risky assets, especially of equity prices in Asia and to a lesser extent in other regions of developed markets (DM), as financial markets were hit after digesting lower global growth rates of the world economy. Given the current information about the imposition of US tariffs and the Chinese reaction, we still believe that a de-escalation on global trade appears possible, as the example of the temporary suspension of the tariffs for steel and aluminum between the US and the European Union shows that renegotiations with the Trump administration are feasible. In addition, the scope of the announced tariffs and the impact of these measures on global growth so far appear to be exaggerated. After all, these tariffs represent approximately 0.2% of total US imports and around 10% of the US trade deficit, while the imposed tariffs on China account for 0.1% of the Chinese GDP and only 2.2% of China's total exports. Given the current information about tariffs and retaliation, and the negligible impact on the global economy, we would compare the current skirmish to an ice cube, not the tip of an iceberg.

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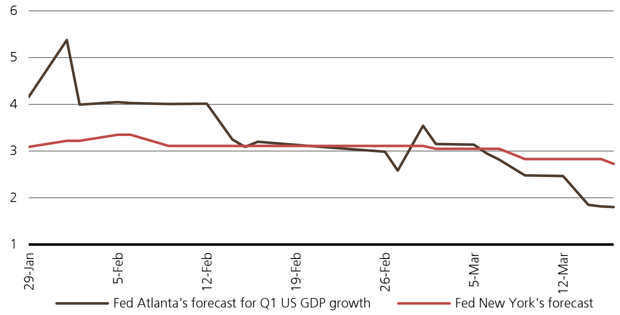
Global growth – At target

Although global growth and inflation data over the past month have slightly undershot forecasts, we still adhere to our base-case scenario of solid global economic growth and moderate inflation. Data released over the past month suggest that global growth may be peaking. This development prompted some analysts to forecast a downturn in near-term global economic activity. While subdued inflation data across DM could imply slightly higher-than-estimated labor slack, it may also indicate that DM economies have the potential to grow more than anticipated. Even though the Atlanta Fed now forecasts that US economic growth in the first quarter has dropped to 1.8%, from 3% a month ago, the Federal Reserve Bank of New York estimates GDP growth is relatively stable at slightly below 3%.

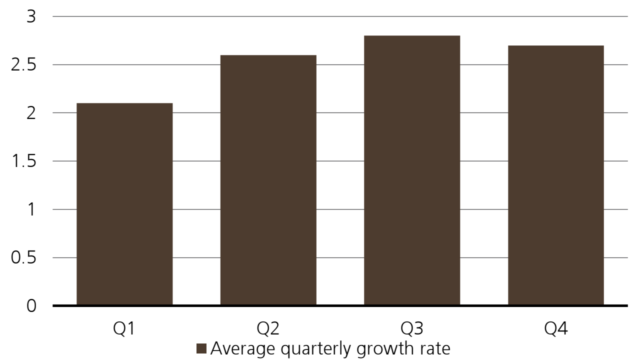
Forecasts for US GDP growth in the first quarter 2018 has dropped



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

However, the mixed data flow suggests a temporary pause in an otherwise still positive global growth trajectory. In addition, it is a well-known statistical phenomenon, called residual seasonality, that US GDP growth in the first quarter is substandard compared to the growth rates realized in the other three quarters. Since the early 1990s, the US economic growth rate in the first quarter is seasonally and work-day-adjusted lower by around half a percentage point on average than the rates for the second to the fourth quarter. Therefore, economic activity is expected to re-accelerate again during the remainder of the year. Even though job growth is trending lower, it has still been robust recently and continues to run above the replacement rate, reducing the unemployment rate further. Hence consumption continues to be the engine of the expansion.

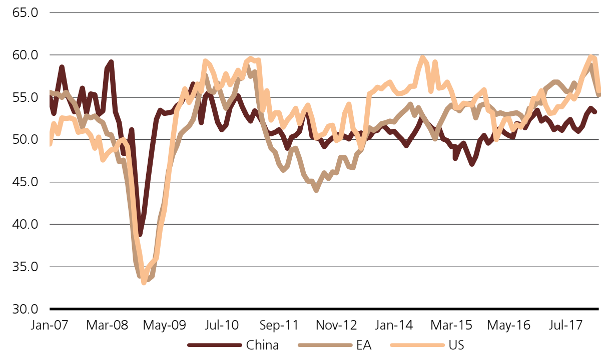
Residual seasonality – average quarterly growth rates for US GDP since 1990



Source: Federal Reserve Bank of St. Louis, UBS-SFA

The boost to after-tax income is now raising the savings rate and will allow consumption to strengthen in the coming months. Business equipment investment has been steadily expanding and manufacturing payrolls have been growing strongly in the US according to the Federal Reserve Board. Housing investment may slow temporarily due to rising mortgage rates. Although leading indicators in the euro area (EA) and in Germany, such as the PMI and the IFO surveys, signal that the period of economic growth acceleration may be slowing, as they are now down for the second consecutive month, both indicators remain at a very high level from a historical perspective and are still consistent with an increase in economic activity of around 2.5% in EA.

Purchasing manager indices (PMI)



Source: Bloomberg, UBS-SFA, as of March 2018

In Japan, real GDP growth is forecast to grow by slightly below 2% in 2018. The initial result of spring wage negotiations indicates that wage hikes are not enough to change the benign view on consumption and inflation. Recent comments by BoJ Governor Kuroda suggest monetary policy will stay unchanged until 2019. In the emerging markets, some kind of "Goldilocks" conditions still prevail in the Asian region, especially for current account "surplus" economies. Concerns on trade protectionism have escalated, but the region's exports momentum appears to be resilient. Growth still looks robust despite some interim slowdown.

Monetary policy divides – Inflation remains a toothless threat

We have often highlighted that the Fed appears steadfast in its desire to gradually normalize policy by raising interest rates and reducing the size of its balance sheet. Jerome Powell, the Fed's new Chair, represents much continuity with this approach, even though his recent, relatively candid, congressional testimony suggested that he may now expect to vote for 100bp of hikes this year. Among other DM central banks that are turning more hawkish, Norges Bank lifted its interest rate path again to suggest a first 25bp hike in the second half of 2018, after having recently revised its monetary policy mandate to an inflation target of 2.0%, from 2.5%.

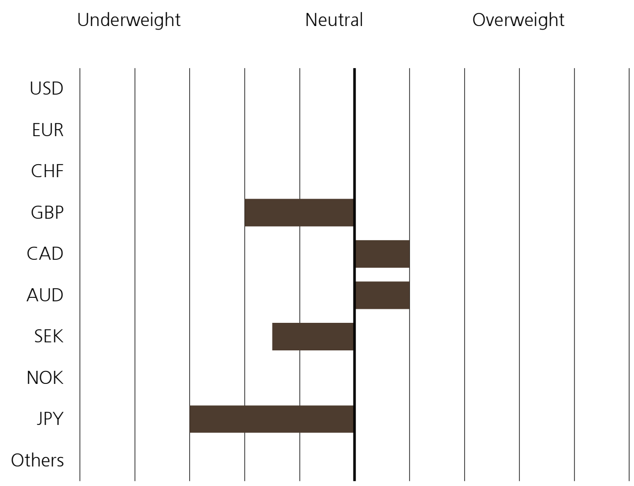
However, the tightening trend is not uniform among DM central banks, as we have also consistently noted. The ECB's latest press conference and speeches of ECB officials at the ECB's conference reinforced the bank's cautious attitude to policy tightening and its continued emphasis on "confidence, patience and persistence". Recent ECB communication has focused on the discrepancy between strong real data and subdued inflation, and the associated uncertainties around estimates of potential growth. The ECB's cautious attitude is justified by the asymmetry of the risks which it faces (the ECB has plenty of options to tighten policy, but little ammunition to ease). Its focus on potential growth may be one effective way for the ECB to communicate that it will react to realized inflation (rather than be proactive, i.e. rely heavily on its projections of inflation). In our view, that would still allow the ECB to end its net asset purchases around year-end but would argue for a delayed first hike in the policy rate.

Investment conclusions

Global foreign exchange – Range bound!

The dollar has depreciated significantly over the last 14 months, following a long period of dollar strength during which the US Dollar Index (DXY) and the broad nominal trade-weighted dollar exchange rate appreciated by 24% between the spring of 2014 and early 2017. The reasons for recent USD weakness are difficult to identify definitively, but probably involve some combination of a high initial valuation, an upward revision of the growth and monetary policy prospects in the rest of the world (RoW), an associated increase in desired portfolio allocations for the RoW and perhaps a rising risk premium for USD-denominated assets in the light of the rising "twin deficits" in the US.

Currency allocation preferences (six months)



Source: UBS-SFA, April 2018

However, it seems that the risk of a hawkish intensification from the Fed has faded for now, together with the fear of a sudden acceleration in US inflation. At the same time, the expectation has risen that the ECB may further reduce the magnitude of accommodation given the acceleration of economic growth in EA, declining unemployment and rising job creation, even though the first rate hike by the ECB is now postponed and projected to take place sometime in mid-2019. Still, the expectation of a less accommodative policy stance by the ECB may support the EUR, leading the USD to trade in a narrow range of 1.20 to 1.28 against the EUR because the Fed's normalization policy is fully priced in.

Global bonds – Moderate spread widening in the investment grade corporate space

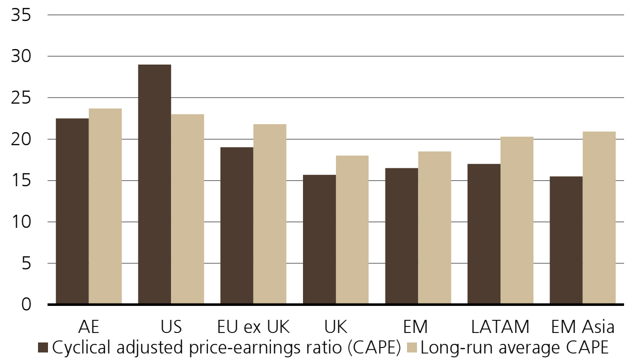
While government bonds yields declined in the aftermath of the introduction of tariffs by the US administration due to safe haven flows – the yield of the 10-year US government bond dropped by 10 basis points and the yield of the 10-year German government bond by even more than 25 basis points – spreads for corporate debt widened by around 15 basis point at the same time. This means they have underperformed sovereign bonds of DM economies. As we are still constructive that a de-escalation between the US and the Chinese administration is possible in the course of the coming weeks, we continue to prefer corporate bonds over government bonds, at least for EUR- and CHF-denominated debt. Given the ultra-loose monetary policy in EA and by the Bank of Switzerland, yields for government bonds up to 5 years are still negative in EA. With the recent spread widening, the attractiveness of investment grade corporate bonds has increased in risk-adjusted terms. We are therefore maintaining our overweight allocation to investment grade corporate debt. Should de-escalation fail, our portfolios will benefit from our preference for longer-term maturities. In such a case, the yields for longer-dated bonds should decline again in response to safe haven flows.

Global equities – Maintain an overweight allocation despite concerns about a flattening of global demand!

We have seen a relatively harsh response by the global equity markets to the announcement of the introduction of additional tariffs and a host of new measures that will apply to inward and outward investment between the US and China. As a result, markets began to price in the expected economic consequences of rising protectionism in world trade. These include a slowing in global trade, and hence global demand, a potential deceleration in global GDP growth and, last but not least, lower earnings growth.

We are confident that our base-case scenario of sustained and synchronized economic growth with a solid outlook for earnings remains intact. An in-depth analysis reveals that last week's sell-off was being driven mainly by fears that the current skirmish may escalate into a trade war – a risk that we cannot rule out. However, as nobody has an interest in threatening the current stage of the business cycle and risking a significant drop in economic activity, we still see plenty of scope for US/Chinese negotiations over future trade policy between these two economies. The temporary suspension of steel and aluminum tariffs between the US and the European Union shows that renegotiations with the Trump administration appear possible. The same is true of the US's willingness to reshape the NAFTA Act between the US, Canada and Mexico. Official negotiations began last year. We are therefore optimistic that representatives of these two countries will grasp the opportunity to find a reasonable negotiated settlement, avoiding an aggravation of trade relations between China and the US.

World equity valuation*

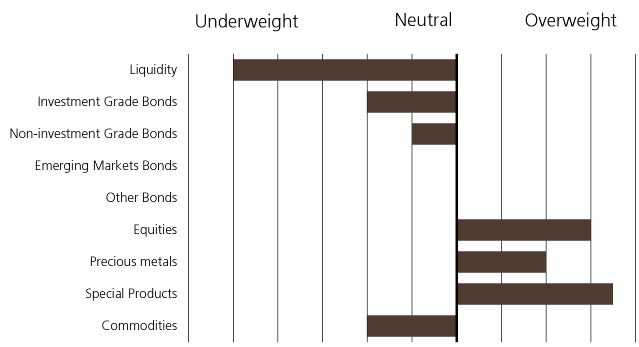


Source: Datastream, UBS-SFA, *Cyclical adjusted price earnings ratios

We are consequently maintaining our overweight allocation to global equities by overweighting EA and US equities and keeping the underweight allocation to UK stocks. We also used February's drop in share prices to extend our exposure to global equities. We remain constructive on local-currency emerging market bonds too, as the upward drift in US yields appears limited in our view. In addition, our allocation to risk premium strategies as an uncorrelated source of return should help us to steer portfolios through this challenging market environment.

We advise investors to consider rebalancing their portfolio allocations to their target ranges, and that those who are still standing on the sidelines take this opportunity to build up exposure to global equities. At the same time, we stress that diversification – by searching for assets with low or even negative correlation – is the most important element in balancing portfolio risks and returns.

Asset allocation preferences (six months)



Source: UBS-SFA, April 2018