Macro Monthly

Economic insights and asset class attractiveness

UBS Asset Management | August 2023

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

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Addressing three potential challenges to a soft landing

Highlights

- A soft landing has become more likely, but it has also become more priced into financial markets.
- Here we address three challenges to our constructive outlook: richer valuations, soft economic activity outside the US and sticky high inflation.
- Global equities are less expensive than they appear at the index level: most stocks are still at reasonable valuations, including the US equal weight index and mid-caps.
- We expect that manufacturing activity, which has been stagnating, will catch up to services rather than the other way around.
- A higher-than-desired plateau for inflation may take shape during Q4 or into 2024, but this would likely be associated with continued resilience in economic activity, in our view.

US economic and inflation data are validating our view that a soft landing for the economy is increasingly likely.

Solid reports on everything from the labor market to durable goods orders in the US have mitigated fears that central bank tightening to date will spark an imminent recession. And recent inflation figures have reduced the odds that central banks will need to deliver ever-tighter monetary policy in order to cool price pressures.

But as a soft landing has become more probable, this good news has also been more priced in to financial markets. We view the increasing popularity of positions associated with more benign economic outcomes, softness in global activity outside the US, and the potential for renewed stickiness in inflationary pressures as three of the key challenges to the soft landing thesis. While we are closely monitoring these risks, in our view, these threats to the expansion and market rally are likely to be overcome. Positioning for a soft landing still appears to be an attractive risk-reward proposition.

We continue to be overweight global equities, and prefer exposures more levered to US economic strength. These include the S&P 500 equal-weight index, US mid-caps, and cyclicals over defensives.

Popular, not yet crowded

Investor sentiment and some measures of positioning have normalized substantially after being depressed for a prolonged period. As such, risk assets have grown more susceptible to any incremental news that violates the soft landing thesis.

There is no denying that US stocks, particularly at the aggregate level, are expensive on an outright basis and relative to bonds. This is one reason why we believe that government bonds continue to warrant a place in portfolios, thanks to their diversifying properties in the event of an economic slowdown and their attractive yields. But while stocks are

expensive at the index level, there is a large disparity between a select group of mega-cap tech stocks and the vast majority of US large and mid-caps – our preferred exposures – which are more fairly priced.

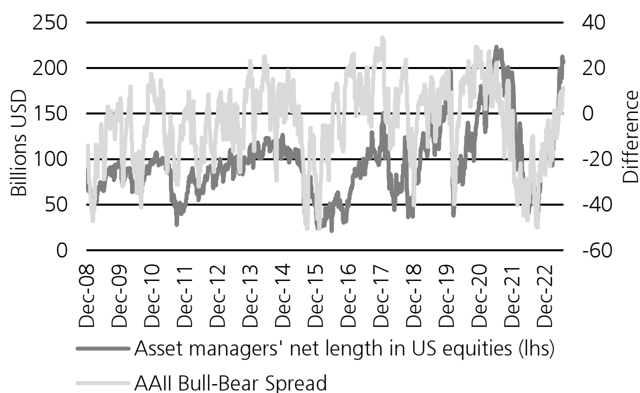
This combination of high valuations and normalized positioning must be balanced against the market and macro fundamentals, which we believe are still strong. Earnings are surprising to the upside by a healthy amount this year after more modest outperformance vs. expectations for most of 2022. Twelve-month forward earnings-per-share estimates are increasing – nearing their record highs from mid-2022. Twelve-month forward earnings-per-share estimates are increasing – nearing their record highs from mid-2022. Twelve-month forward earnings-per-share estimates are increasing – nearing their record highs from mid-2022. When profit expectations are rising over a three-, six-, or twelve-month period, global equities have a strong positive hit rate. The return of positive real income growth, which in turn is boosting consumer confidence, increases our conviction that the bottom-line outlook for corporates will continue to improve.

Exhibit 1: Forward returns for MSCI World positively skewed when earnings estimates are rising

	Returns when 12M fwd EPS growth positive		**Returns when 12M fwd EPS growth negative**	
Starting forward P/E	3M	6M	3M	6M
>18x	2%	3%	-1%	-4%
16x-18x	2%	5%	-1%	-1%
14x-16x	3%	6%	0%	1%
<14x	4%	8%	-2%	-3%
Current P/E: 17.6				

Source: UBS Asset Management, Bloomberg. As of July 2023.

Exhibit 2: Institutional investor net long positions in US equity futures, individual investor sentiment normalizing



Source: UBS Asset Management, CFTC, American Association of Individual Investors. Data as of July 2023.

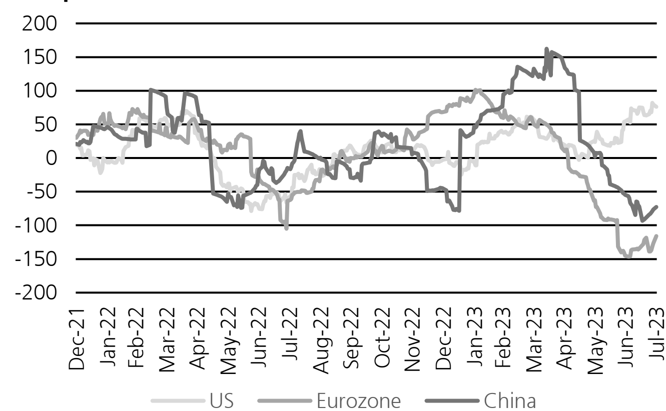
Ex-US softness
Compared to the US, other major economic regions are not Performing as well relative to expectations.

Global industrial production has moved sideways in volume terms for over a year, with a shift in consumption from goods to services and elevated energy costs serving as a drag on activity. Europe's economy is more exposed to the manufacturing sector, and also more sensitive to higher interest rates since bank loans account for a higher share of corporate financing.

Traditionally, more cyclical industries have been leading indicators for where the rest of the economy is going – and if this were to hold true, weakness in the factory sector globally would be expected to bleed through into other parts of the economy – and eventually weigh on the US, as well.

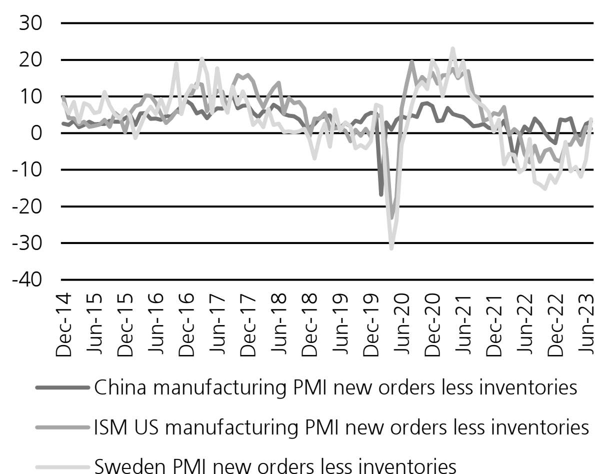
Yet this has been anything but a normal economic cycle. Pandemic-related shifts in goods and services demand have disrupted the typical leading properties of manufacturing to services. Rather than weakness in the goods sector bleeding into services, we think solid real income growth should allow for an inventory replenishment cycle and pickup in goods spending. Indeed, we see tentative signals of a bottoming in the sector in the internals of manufacturing purchasing managers' indexes. The Citigroup Economic Surprise Index, which measures data relative to economist expectations, shows the US surprising to the upside, but not China or Europe.

Exhibit 3: US economy surprising to the upside unlike, Europe, China



Source: UBS Asset Management, Institute for Supply Management, China Federation of Logistics and Purchasing, Swedbank Markets, Macrobond. As of July 2023.

Exhibit 4: Improving internals for manufacturing survey data



Source: UBS Asset Management, Institute for Supply Management, China Federation of Logistics and Purchasing, Swedbank Markets, Macrobond. As of July, 2023.

Sticky growth, sticky inflation?

We doubt that in the near term the monthly US inflation prints will be quite as low as the June CPI report, where declines in select volatile categories helped contribute to an especially subdued print. And looking ahead to the fourth quarter, we are also wary that some of the seasonal factors currently suppressing core CPI inflation are likely to reverse and boost price pressures.

However, we do believe that upcoming reports will be sufficiently soft to confirm that monthly CPI inflation has downshifted to closer to 0.2% than 0.4%, which had been average for 2023 through May. The slowdown in nominal spending growth and continued deceleration in shelter price growth will be the dominant forces that allow for a continued improvement in inflation outcomes through at least year-end, in our view.

That said, the recent upturn in commodity prices, particularly oil, and potential for a pickup in global industrial activity threaten to increase the stickiness of above-target inflation beyond the very near term. This is not just for headline price pressures, which include energy, but also elements of core inflation like airfares, food services, and other parts of core goods in which fuel prices are a key input.

In our view, any difficulties in getting inflation the 'last mile' back to the Federal Reserve's target may constrain how many rate cuts the central bank can deliver in 2024. But it would also likely be associated with enduring resilience in activity – the kind of backdrop in which little monetary policy easing is required to keep the expansion on track and corporate profits moving higher.

Asset allocation

Although we continue to scrutinize risks to a soft landing materializing, we still have conviction that core inflationary pressures will moderate while growth remains resilient over the tactical investing horizon.

We believe the best way to express this macro view is through overweight positions in equities, rather than bonds. In particular, we favor more cyclical parts of the US equity market. We retain a neutral weighting toward government bonds, which play an important role in diversifying our more risk-on, procyclical positions. The outlook for growth is still solid, however, which limits how much bond yields can fall, even as inflation moves lower.

Asset Class Views

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 31 July 2023. The colored squares on the left provide our overall signal for global equities, rates, and credit. The rest of the ratings pertain to the relative attractiveness of certain regions within the asset classes of equities, rates, credit and currencies. Because the ACA does not include all asset classes, the net overall signal may be somewhat negative or positive.

Asset Class		Opportunity Set	UW		N		OW	
Main Asset Classes		Global Equities	□	□	□	■	□	Soft landing odds have gone up with increasing evidence of solid activity, disinflation. Prefer US equal weight.
		Global Gov	□	□	■	□	□	Disinflation offset somewhat by resilient growth. Still decent carry and a useful hedge for recession risk.
		Global Credit	□	□	■	□	□	Attractive all-in yields amid resilient growth and disinflation. But limited room for spread compression.
		Commodities	□	□	■	□	□	Resilient demand, positive supply surprises may have run their course. Requires stronger China for more upside.
Preference by Asset Class	Equities	US	□	□	□	■	□	Despite strong gains off the lows, equal weight index is not particularly expensive.
		Europe	□	■	□	□	□	Funding US equity exposure out of Europe on soft manufacturing, stubborn inflation and China weakness.
		Japan	□	□	□	■	□	Still cheap after recent gains, solid earnings, corporate reform ongoing, Prefer to express in FX unhedged terms.
		EM	□	□	■	□	□	EM outperformance requires more China stimulus. Asia ex-China supported by tech goods rebound.
	Duration	US Treasuries	□	□	■	□	□	Rates have repriced to reflect US economic strength and now look more reasonable.
		Bunds	□	□	■	□	□	Manufacturing weakness, bank stress but strong labor market and stickier inflation.
		Gilts	□	□	■	□	□	Green shoots on inflation allows BOE to be less aggressive on rate hikes.
	Credit	Investment Grade Credit	□	□	■	□	□	Narrow spreads means risk-reward confined to carry.
		High Yield Credit	□	□	■	□	□	Slight preference for IG versus HY. Moving up in quality in context of broader risk-on positioning.
		EMD Hard Currency	□	□	■	□	□	EMD attractive on decline in rate volatility, higher real rates. Big divergence between EM IG and EM HY.
	FX	USD	□	□	■	□	□	Strong US growth but disinflation offset to a broadly neutral USD. Bullish against EUR, bearish against EM FX.
		EUR	□	□	■	□	□	Growth impulse moving to the US and in case of US recession, Europe unlikely to decouple.
		JPY	□	□	□	■	□	JPY is cheap vs. USD, and the BoJ is beginning to tighten. Safe haven JPY a good hedge against recession.
		EM FX	□	□	□	■	□	Not too hot, not too cold economy is good for carry. Prefer MXN and BRL.

Negative ⟵⟶ Positive

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of July 31, 2023. 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.

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Americas

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