

Macro Monthly

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qualified / institutional clients
and investors and US retail
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For marketing purposes.

UBS Asset Management | Economic insights and asset class attractiveness
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A higher volatility regime

Highlights

- Markets have entered a higher volatility regime as Fed tightening, end-of-cycle concerns and geopolitics come into play
- Higher volatility demands careful risk management and by definition offers more tactical trading opportunities, but in our view it does not necessarily mean investors should significantly reduce overall equity exposure
- Bear markets (>20% drawdowns) are rare outside of recessions; at this point, a US recession over the coming year is not our base case
- We remain focused on leading economic data and credit spreads for signs that a genuine turn in the cycle is imminent

In our inaugural Asset Allocation Quarterly, we named ‘higher volatility’ a core investment theme for coming months. Specifically, we said ‘as the cycle matures, the range of potential growth, inflation and interest rate outcomes is broadening from the very narrow range investors have been used to for much of the past decade post-financial crisis.’ The sharp rise in market volatility in October was a particularly acute illustration of this changing environment. And while we do expect volatility to calm somewhat from elevated levels over coming weeks, we also think the overall ‘volatility regime’ will be structurally higher than what investors have been used to over recent years. This does not mean we are of the view a bear market has begun—we do not think it has. But October’s price action is a reminder that returns in multi-asset portfolios are likely to be more muted on a risk-adjusted basis, and portfolio management will probably require more tactical positioning as we move into the late stages of the economic cycle. In this Macro Monthly we discuss our views on recent market volatility, why we believe we are in a higher volatility regime, and how we are navigating this environment in our portfolios.

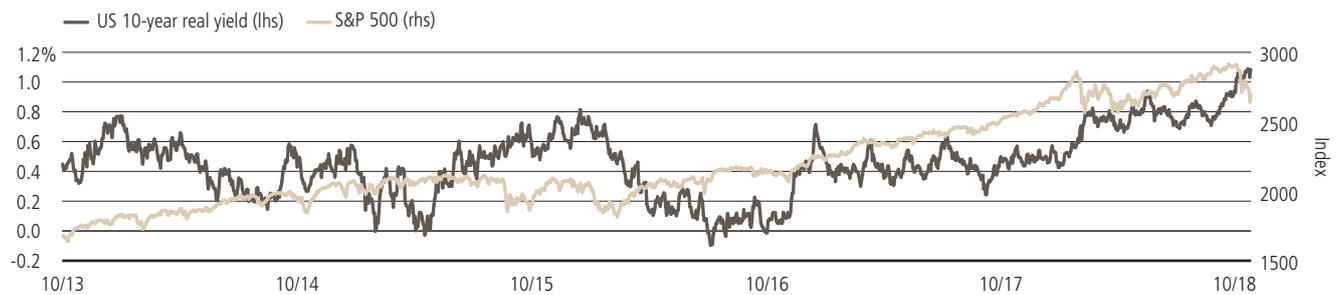
What happened?

Since reaching an all-time closing high on September 20th, the S&P 500 underwent a 10% correction, bringing year-to-date performance flat for the year. Global equity markets have fallen largely in line, although most major indices outside of the U.S. were already down year-to-date, pressured by moderating ex-US growth, associated concerns of China’s deleveraging, and perceptions that trade tensions will weigh on exports and company earnings. The proximate catalyst for the sell-off was a sharp rise in US 10-year Treasury yields (about 40 bps over 6 weeks), driven largely by more hawkish guidance from the US Federal Reserve. In particular, it was the

breakout in 10-year real, or inflation-adjusted, yields to 5-year highs which began to challenge market valuations and assumptions about how high interest rates can go (Exhibit 1). More recently, concerns about 'peak earnings' and fears that this long economic expansion will soon come to an end have added to the selling pressure. While Q3 earnings and guidance have not been particularly negative, the smaller proportion of revenue beats relative to recent quarters and commentary on rising labor and raw material input costs have led to a reassessment of the multiple investors are willing to pay for future earnings estimates. And in the background, US-China trade concerns, US political uncertainty and tensions between Italy's populist government and the EU have all contributed to shaky markets.

Exhibit 1: Real yields breaking out of a 5-year range a key catalyst for the equity sell-off

US 10-year real yields and S&P 500



Sources: UBS Asset Management, Macrobond. Data as of October 25, 2018.

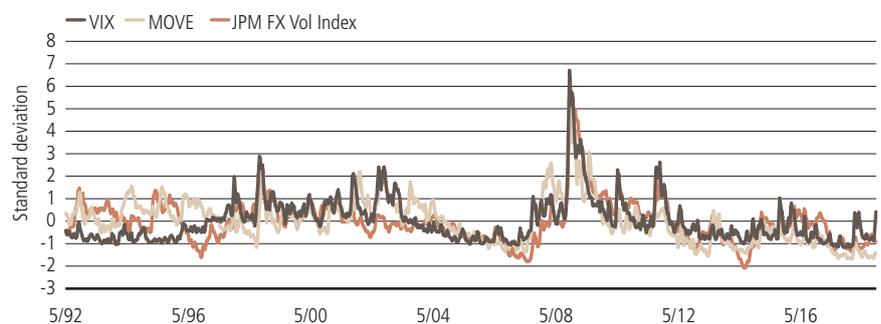
Entering a higher volatility regime

But the overarching picture here is that market volatility has been suppressed by low macro variability (growth and inflation) and accommodative monetary policy for years, and that pressure is now starting to release (Exhibit 2). As central banks remove accommodation and the uncertainty over growth and inflation rises, markets will naturally become jumpier as they price in a wider variety of future outcomes. With the unemployment rate the lowest it has been in 50 years, the market must price some probability of an acceleration in inflation, just as it must also price in some possibility of a sharp downturn. And the Fed has the unenviable job of threading the needle to engineer a soft landing.

The Fed's job gets more difficult the more it progresses in this tightening cycle and comes close to unobservable variables like R*, the real short term interest rate that should prevail when the economy is at equilibrium, and markets must price in that uncertainty. Exhibit 3 shows how historically equity market volatility has tended to lag the start of Fed tightening cycles by a couple of years. In truth, the objective of tightening monetary policy is indeed to also tighten broader financial conditions, thereby ensuring the economy and

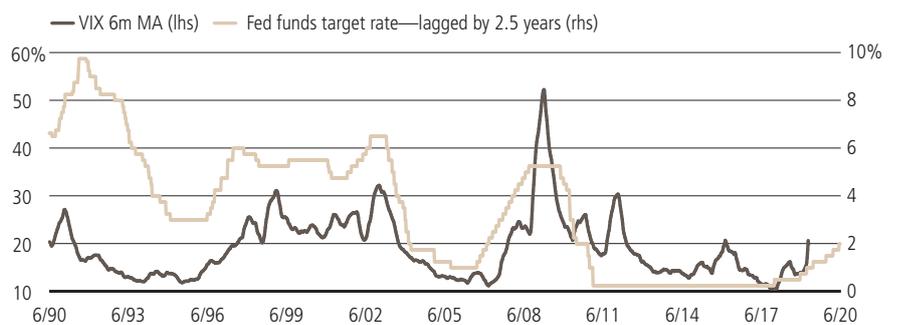
Exhibit 2: Volatility has been below historical averages for much of the post-crisis recovery

Normalized volatility indices (3-week moving average)



Sources: UBS Asset Management, Bloomberg LLC. Data as of October 26, 2018.

Exhibit 3: The VIX has lagged the start of Fed tightening cycles by about 2.5 years



Sources: UBS Asset Management, Bloomberg LLC. Data as of October 25, 2018.

financial markets do not overheat. Exhibit 4 shows how for much of this Fed tightening cycle, broad financial conditions have actually eased. With the latest spread of financial stress, one could argue the Fed is now finally achieving its goals. But fears of a Fed policy mistake will rise the more the Fed continues on its rate path, if not matched by a still strong economy. And there are few signs that geopolitical concerns are going away, with US-China tensions broadening more explicitly from the trade deficit to concerns about security and geopolitics. In short, we believe that genuine uncertainties on the macroeconomic outlook will stay with us, and markets will likely remain bumpy trying to price all of these factors in.

Where do we go from here?

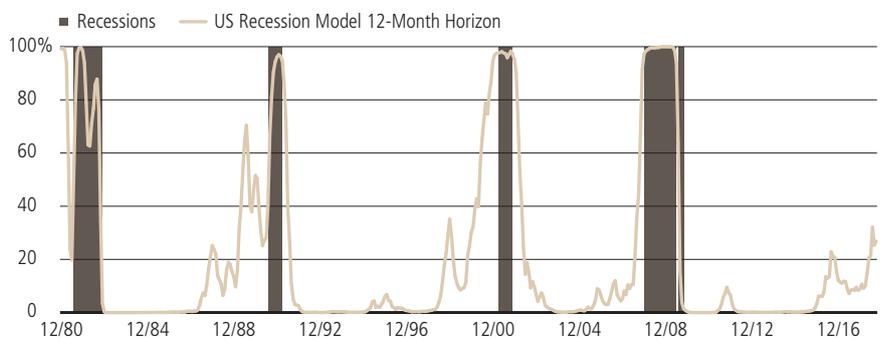
While markets will likely show more volatility, we are of the view that we are closer to the end of this drawdown than the beginning. While 10% corrections in the S&P 500 are quite common historically, it is rare to have a bear market (greater than 20% drawdown) outside of recessions. Since 1970, there has only been one S&P 500 bear market outside of a recession, which was Black Monday, October 19th 1987. At this point, most leading economic indicators in the US are still robust, and our proprietary recession probability model (Exhibit 5) signals about a 1 in 4 chance of a recession over the next 12 months—not negligible, but not our base case. In the meantime, China’s authorities have announced a series of monetary, fiscal and regulatory easing measures which should cushion the world’s second largest economy and have stabilizing knock-on effects for trade-sensitive economies from emerging markets to Europe. As the evidence of these measures begins to take hold in the data over coming months, we’d expect markets to stabilize. So while further declines in the S&P 500 are quite possible, we do not at this point expect a 20% bear market or worse. In our view, this will end up being a re-pricing, as opposed to the beginning of the end of the economic cycle. Our judgment would change if US and global economic data show genuine signs of deterioration, or if credit spreads (typically a leading indicator for a turn in the economic cycle), start to widen out much more severely.

Exhibit 4: Financial conditions are only now beginning to tighten



Sources: UBS Asset Management, Macrobond. Data as of October 25, 2018.

Exhibit 5: Odds of US recession within 12 months are still moderate



Sources: UBS Asset Management, Macrobond. Data as of October 26, 2018.

Exhibit 6: Historical S&P 500 drawdowns suggest 20%+ bear markets are rare outside of recessions

S&P 500 drawdowns since 1929	S&P 500 drawdowns since 1929			Median depth	Median length (months)	Median to trough (months)	Median recovery (months)
	10%+	20%+	25%+				
Recession	10	8	7	-31.6%	24	13	12
No Recession	11	3	1	-14.2%	5	2	4

Sources: UBS Asset Management, Bloomberg LLC. Data as of October 25, 2018.

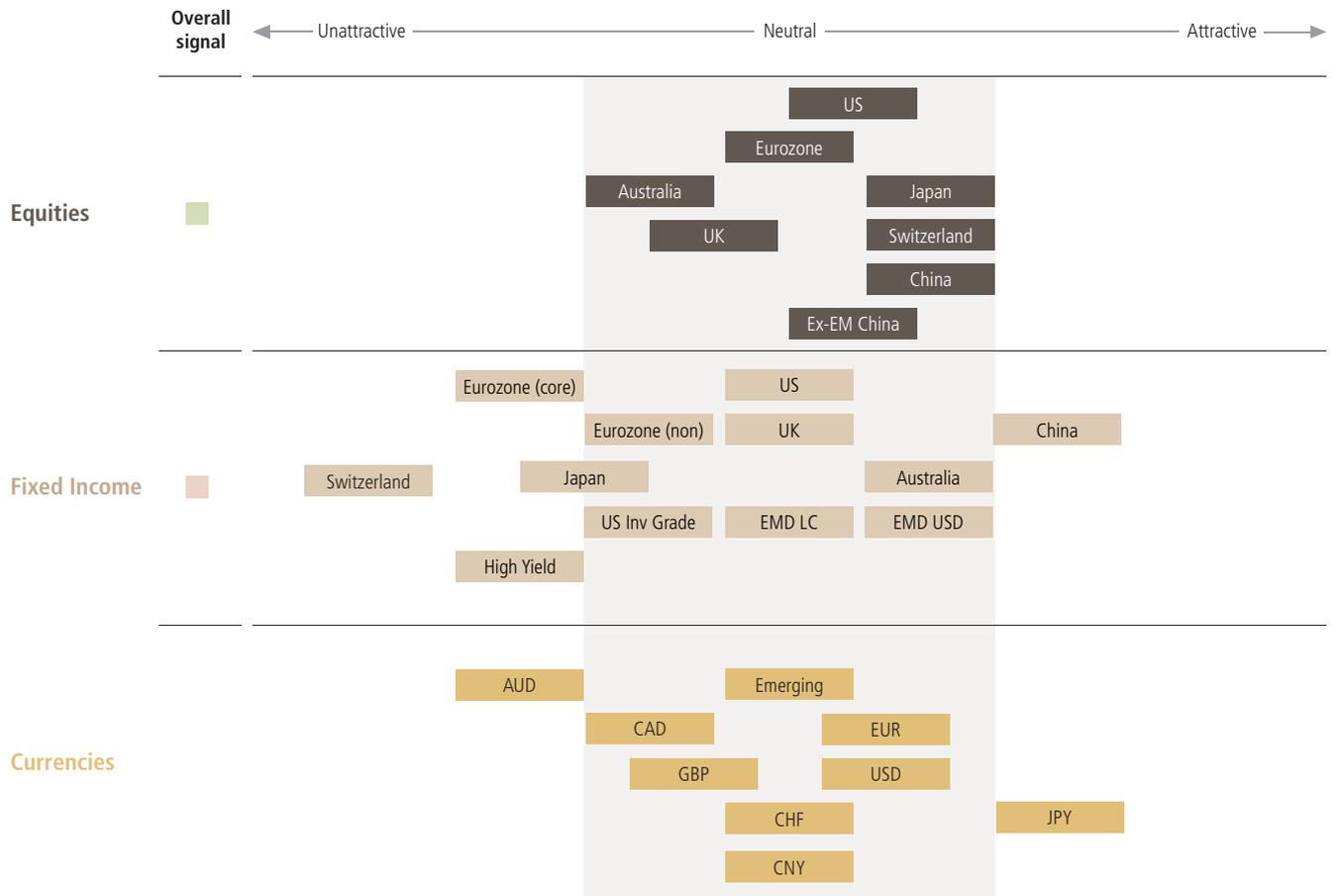
The bottom line: Asset allocation

Higher volatility demands careful risk management and potentially more tactical exposure, as opposed to less active buy and hold strategies in equities and bonds. But it does not imply going underweight equities, providing this above-trend growth phase of the global economic cycle is still intact—and this remains our base case. The sharp derating of equities is likely to create opportunities to buy US equities given a still solid economic and earnings backdrop, emerging market equities given attractive valuations (while mindful of the interaction between trade tensions and China’s fiscal stimulus), and Japanese stocks on supportive domestic reforms and reflation. We retain our underweight in US high yield in case we are wrong about the economic cycle and are overweight the Japanese yen to protect against further flights to safety.

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 October 31, 2018.



Source: UBS Asset Management Investment Solutions Asset Allocation team as at October 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.

Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		<ul style="list-style-type: none"> While the US economic cycle is mature, consumer spending and stimulative fiscal policy provide support for growth. The length of the cycle will depend on whether productivity growth can continue to move higher off the lows of 2016. Stronger-than-expected corporate earnings growth, rising M&A, improving manufacturing activity and increasing capital returns to shareholders are likely to remain key supports in the coming months. The recent derating of the US equity market has created value assuming this above-trend growth phase of the economic cycle still has legs, which we think it does.
Global (Ex-US) Equities		<ul style="list-style-type: none"> In Europe, the increased risk premium prompted by recent political developments in peripheral Europe will likely constrain upside potential until more clarity emerges around the relationship between Italy's populist government and the European Commission. Despite these short-term headwinds, our longer-term base case remains positive, supported by decent demand growth, and the potential support to earnings from balance sheet optimization. With political uncertainties around Abe's re-election gone, we view Japanese equities as attractive. Ongoing structural reforms support a higher rating while building economic momentum suggests the outlook for profits growth is stronger than markets are currently discounting.
Emerging Markets (EM) Equities including China		<ul style="list-style-type: none"> Emerging market equities have struggled in recent months in the face of a strengthening USD, rising USD funding rates and rising geopolitical risks. We do not dispute that these factors present headwinds. But in aggregate fundamental conditions remain relatively robust and the recent share price weakness across EM feels out of kilter with these fundamentals. We no longer have a clear preference for Asia (ex China) within the broader EM universe. In our view, attractive valuations are now at least partially countered by vulnerability to any escalation in the US/China trade war. We remain broadly positive on China. Any broadening of the current trade standoff with the US is likely to hamper Chinese growth, but 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 ongoing 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		<ul style="list-style-type: none"> After recent repricing of the Fed's outlook, US Treasury yields are now much closer to fair value. US Treasury yields remain low by historical standards, but look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pickup in inflation or term premium, yields are likely to remain range bound. Our overall assessment is neutral.
Global (Ex-US) Bonds		<ul style="list-style-type: none"> In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB has committed to low rates into next year, so we see limited opportunity in Europe. 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. Elsewhere we are more positive on Australian and Canadian duration on a relative basis. In our view, both economies are vulnerable to a housing market correction after very strong recent performance.
Investment Grade (IG) Corporate Debt		<ul style="list-style-type: none"> Geopolitical turmoil and trade issues have spilled over into the credit markets, causing IG spreads to widen slightly 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		<ul style="list-style-type: none"> Current default rates in high yield are very low by historical standards. Given the relatively positive economic backdrop, we do not expect any material pickup in US corporate debt defaults in the near term. However, while spreads have widened in recent weeks, we do not yet view the risk/reward as attractive.
Emerging Markets Debt US dollar Local currency		<ul style="list-style-type: none"> Spreads on EM debt relative to US treasuries have widened substantially in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates – sparking particular fears for EM countries with large external funding requirements. This sell-off is probably overdone at least in the hard currency space where average rating is BB+ compared to B+ for the US higher yield while EM sovereign spreads are wider. We remain neutral for local currency bonds as long as we don't expect a significant near-term rebound in Chinese economic activity.
Chinese Bonds		<ul style="list-style-type: none"> China has the third (soon the second) largest fixed income market in the world. Chinese bonds have the highest nominal yields among the 10 largest fixed income markets, yet have delivered the strongest risk-adjusted returns of this group over both 5 and 10 years. Slowing economic growth and inclusion to the Bloomberg Barclays Global Aggregate index next year should push yields down during the next 3-12 months.
Currency		<ul style="list-style-type: none"> The rise in US yields provides support for USD, but as signs of stimulus from China begin to take hold, we expect ex-US growth to stabilize. Over time, we anticipate capital will flow from the US into earlier-cycle economies, especially as the USD remains somewhat expensive on a real trade-weighted basis. Elsewhere, we continue to see strong valuation support for the JPY.

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Americas

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EMEA

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