UBS

For professional / qualified / Institutional clients and wholesale fund selectors investors only

The impact of inflation

UBS Asset Management | Viewpoints Market Outlook 2022

On November 30, **Benno Klingenberg-Timm,** Head of Global Sovereign Markets, APAC, moderated a conversation with **Evan Brown,** Head of Macro Asset Allocation Strategy, and **Hayden Briscoe,** Head of Fixed Income, Global EM and APAC. They discussed whether the inflation debate is relevant for equity and bond investors in Asia.

Inflation, stagflation or reflation?

- Clients are concerned about persistent inflation, as well as the possibility of stagflation on the horizon.
- We believe that true stagflation, defined as a sustained period of slowing growth and rising inflation, is unlikely. If growth should slow, it would likely take inflation down with it.
- We expect growth to be quite strong in the coming year. While there is near-term uncertainty about the Omicron variant, investors shouldn't underestimate the strength of the global economic backdrop.
- This includes fast-growing incomes, continued easy monetary and fiscal policy, and the need for inventory rebuilding.
- In addition, consumers, governments and businesses are getting better at working around COVID. Mobility restrictions are having one-twelfth of the economic impact they did in early 2020. The world is learning to live with the virus.
- In the coming year, we believe reflation is a more likely scenario than stagflation.

Reasons for optimism about the current economic cycle

- We think the market is too pessimistic about where the US Federal Reserve (the Fed) will end up. The market is pricing a terminal rate that is 75 to 100 basis points (bps) below where we ended up in the last cycle.
- The foundations behind the current cycle are attractive. We have much stronger household and corporate balance sheets going into this cycle. There is considerable fiscal support, in contrast to the fiscal austerity at the beginning of the last cycle.
- In addition, the impulse for more capital expenditures is strong. Given the supply constraints we've seen, and given the emphasis on reshoring due to COVID and US-China trade war, we expect to see much more investment by businesses.
- The coming energy transition will require significant spending by both the public and private sector. The IEA is estimating USD3 trillion in additional spending each year as we approach 2030.
- Those factors point to strong growth going forward. While inflation is surging right now, we expect it to calm down. That said, inflation is a bit higher than it was during the last cycle. It could be a little more difficult for central banks to control, given the strong growth impulse.
- That is why we think the Fed is going to hike a few times in 2022. We believe rates will end up above where we were during the last cycle, around 2.25 or 2.5%.

The impact of higher US inflation on Asian bond markets

- This time around, the emerging markets (EM) saw the first wave of inflation. As a result, EM countries have been hiking rates aggressively, surprising the markets.
- Many countries have hiked as much as 50 or 100 bps. Even those that typically move in smaller increments are raising rates by 25 or 50 bps.
- Net debtor countries that can't afford it are importing inflation aggressively.
- In Asia, inflation is being demand destructive or margin destructive. The Producer Price Index (PPI) is at elevated levels in China, but it's not getting passed on to the consumer. We're seeing margin compression occur in the manufacturing sector.
- We have much higher base effects. But markets move off the rate of change. And in the US, the rate of change is picking up, particularly around the PCE. That is going to drive the Fed.
- For the first half of 2022, it looks like quantitative tightening is going to be pulled forward, and then the discussion around rate hikes will start.
- In the second half of 2022, we should see less room to hike as the rate of change slows.

The impact of China's regulatory changes on long-term returns

- Our long-term capital markets assumptions haven't changed. It's clear that China has entered a period of increased regulation, whether in the property sector or the internet/technology space. But ultimately, it comes down to the fundamentals and the strength of these businesses.

- While there is more uncertainty around regulation, the market has reflected that. We've seen a major derating of Chinese equities relative to the rest of the world. In the property sector in China, in high yield, we've seen a large widening of spreads.
- But the market is compensating investors more for these increased risks.
- After a difficult year, China is becoming increasingly attractive to us as we look ahead, because those valuations have reset.

The goal of China's policy changes

- The current regulatory changes are more complicated than in the past. Previously, new rules focused on a single sector, such as shadow banking in 2017-18, or the oversupply of housing in 2014-16.
- The current changes affect society across the board, because the government is trying to reverse a demographic time bomb. The goal is to get people to have more children.
- To do that, they must meet several needs: housing that can hold larger families, a health care safety net and cheaper education.
- Combatting high prices in education and housing can encourage people to change their behavior and have two more children. A lot of these changes are going to be quite sensible.
- We believe we'll see more of a focus on the middle-income bracket, which will lead to a change in leadership in the stocks and bonds that clients should invest in.
- The property sector has already adjusted for the risks of the change that's underway. But it's still clear from a fundamental perspective that demand is outstripping supply. So in the next 12 months, this looks like a very attractive asset class.
- While the US economy is gaining strength, the Chinese economy is continuing to decelerate. Credit impulses are as low as they've ever been, and should come close to bottoming out in the first or second quarter of 2022.
- We believe the Chinese government will provide a base of support to the economy and create a pickup early in 2022.

Determining how Omicron will play out

- Until we know more, we can expect to see plenty of volatility.
- When considering possible scenarios, the easiest reference point is the Delta variant. While it spread quickly, it was not as severe because the vaccines worked.
- We did see a small dip in activity and stress in supply chains. But overall, bonds rallied, which helped risk assets. In equities, we saw a shift from value to growth, from ex-US to the US.
- Until we get further information, one scenario is that Omicron is about the same as Delta or a bit worse.
- The downside scenario is that Omicron evades the vaccines, which would be a strong negative for risk assets. EM countries, particularly those with less-developed health care infrastructure, would be most vulnerable in this environment.
- In developed markets around the world, there would be more mobility restrictions, more cautious behavior, and a meaningful dip in activity until we have a booster that addresses it.
- But there is an upside scenario here, which we don't think many people are considering. Reports from South Africa say that the variant is spreading quickly but with mild symptoms.
- If the variant spreads rapidly but without serious symptoms, many people could develop antibodies and natural protection.
- This could help people view COVID as similar to the flu, something that we just deal with. This would likely result in a cyclical pickup, higher bond yields and more optimism.
- We will be flexible as we watch to see how Omicron plays out.

The potential impact of Omicron in Asia

- Governments have responded much more quickly this time, clamping down on travel to limit the spread.
- It's become clear that, whenever the virus surges, we experience a risk-off environment. There is a draw to capital to the US market, which strengthens the US dollar. That is continuing to put pressure on emerging markets.
- Even if the US pulls forward quantitative tightening, and rate hike expectations ratchet up, we still have a strong growth backdrop.
- In contrast, Chinese bonds are continuing to rally as the economic slowdown accelerates. So we believe that these two large economies are going to have to meet in the middle sometime next year.
- Investors don't have to exit the bond markets completely. There are likely attractive opportunities to be long China while shorting the US and other economies with a pickup in growth.
- Chinese property is the only severely beaten-up credit asset class around the world.
- European investors are making bond allocations to Asia for the first time, breaking it away from their EM debt allocations or global income strategies.
- Europeans tend to have a longer time horizon. This capital allocation could be more permanent, and could have a calming influence over time.
- Given that there are assets with double-digit yields, that have adjusted through the volatility and the potential default expectations, even in a "bad" scenario, this is going to look like a more attractive asset class over time.
- In addition, within high yield assets there tends to be less correlation to rate hikes. That offers a buffer in the credit space, even if rate hikes come through.

The big picture for global asset allocation

- Expected returns are low for developed market bonds. Either we're in an environment where inflation rises significantly and those bonds sell off, or inflation doesn't rise significantly and we're stuck with very poor returns.

- We believe fixed income investors should look to Asia. There is yield to be had, particularly for investors with a medium- to longer-term horizon who can deal with day-to-day volatility.
- We believe Asia high yield is an attractive area. From a defensive perspective, China's government bonds are appealing. Investors can earn 3% while owning a defensive asset. They certainly can't do that in developed markets.
- In equities, of course the expected returns are higher, but there will be plenty of volatility in this macroeconomic environment. If this cycle is more dynamic cycle, with higher inflation and bond volatility, that will lead to broader asset volatility.
- But if we are in a world where inflation is going to be more persistent, then investors should focus on assets that will gain from a higher nominal GDP world – sectors such as energy or financials, and regions like Europe or Japan.
- Dollar strength could weigh on emerging markets, at least for the first half of next year, but within EM, China has attractive valuations and less sensitivity to broader dollar strength.
- In a higher inflation scenario, the negative correlation between stocks and bonds could reverse. While correlations have been negative for 20 years, it was positive for decades before that.
- If inflation goes up from here, and bonds are selling off, and that causes equities to sell off, investors will want to hedge their portfolios with real assets that can hedge your portfolio.
- That includes commodities, but also alternative assets such as real estate and infrastructure. Asset classes that are going to hold their value as prices rise can play a key role in portfolios.

Sovereign investors are focused on building resilient portfolios

- Large investors are prioritizing portfolios that can react to disruption, whether from megatrends like sustainability or urbanization, or from shocks triggered by geopolitical surprises, dramatic changes in any regulatory frameworks, and unexpected events like the pandemic.
- They see the need for a more agnostic, more unconstrained approach to investing, which allows portfolios to react swiftly and in an agile way.
- Sovereign investors are shifting assets into absolute return strategies, particularly hedge funds – both multi-manager/funds of hedge funds, as well as direct investments in hedge funds. They're also investing in unconstrained fixed income and in real assets.
- Truly long term investors such as sovereign investors and pension funds are seeking to align their portfolios to the long-term structural growth that continues to unfold in the EM, Asia and China, despite the short-term volatility that we're seeing.
- We expect markets that have not yet joined the rally of the developed world to do well in the coming years, and large investors are aligning themselves to these countries.

For information purposes by UBS. For professional / qualified / institutional clients and investors only. Published December 2021.

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual fund. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Americas
The views expressed are a general guide to the views of UBS Asset Management as of December 2021. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund.

EMEA
The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document.

Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient.

The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG.

This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

UK
Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

APAC
This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction.

Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed.

You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Australia
This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

Source for all data and charts (if not indicated otherwise): UBS Asset Management

The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

© UBS 2022. All rights reserved.
AMT-1264 1/22
www.ubs.com/am

For professional / qualified / institutional clients and investors only.

UBS